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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

KPMG PEAT MARWICK, CONTROL DATA CORPORATION, NORBERT R. BERG, WILLIAM C. NORRIS, ROBERT M. PRICE, and MARVIN G. ROGERS,
Petitioners,

—v.—

DIANE ABBEY, DAVID WEISGAL, WILLIAM STEINER, WILLIAM RANDALL, and JOHN PAGE,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

STEVEN J. OLSON
A. REID SHAW
Control Data Corporation

Attorneys for Control Data Corporation

CRAIG W. GAGNON
MICHAEL J. BLECK
OPPENHEIMER WOLFF & DONNELLY

Attorneys for Individual Petitioners

**Counsel of Record*

**DEAN I. RINGEL*
ADAM LIPTAK
CAHILL GORDON & REINDEL
(a partnership including a professional corporation)
80 Pine Street
New York, New York 10005
(212) 701-3000

Attorneys for Petitioners

ELLIOT S. KAPLAN
DEBORAH J. PALMER
ROBINS, KAPLAN, MILLER & CIRESI

PHILIP A. BROWN
VORYS, SATER, SEYMOUR AND PEASE

LEONARD P. NOVELLO
General Counsel
EDWIN D. SCOTT
Associate General Counsel
KPMG PEAT MARWICK

Attorneys for KPMG Peat Marwick

QUESTIONS PRESENTED

1. (a) In an action brought under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, is proof of loss causation (as opposed to transaction causation) a necessary element of the claim?

(b) If loss causation is an element of a Rule 10b-5 claim, can it be "presumed" along with reliance where reliance is established solely on a fraud-on-the-market theory under this Court's decision in *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988)?

2. Is the fraud-on-the-market presumption effectively rebutted where the market price of the stock was concededly unaffected by disclosure of the alleged misrepresentation?

PARTIES BELOW

The petitioners identified in the caption are all of the remaining defendants below. The respondents identified in the caption were the named plaintiffs below. They represent a class of approximately 10,000 purchasers of Control Data Corporation common stock in the open market between January 7 and August 6, 1985.

Pursuant to Rule 29.1 of the Rules of this Court, KPMG Peat Marwick informs the Court that it is a partnership with no ownership interest held by members of the public and Control Data Corporation informs the Court that it has no parent corporation and that its non-wholly owned subsidiaries, defined as active corporations in which Control Data has greater than 50%, but less than 100%, ownership are: Systime PLC Holding and Micro-Quartz Technology Corporation.

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Petitioners KPMG Peat Marwick ("Peat Marwick"), Control Data Corporation ("CDC"), Norbert R. Berg, William C. Norris, Robert M. Price and Marvin G. Rogers respectfully pray that a writ of *certiorari* issue to review the order of the United States Court of Appeals for the Eighth Circuit, entered on May 10, 1991. Petitioners, as defendants-appellees below, timely filed a Petition for Rehearing and Suggestion for Rehearing En Banc, which was denied without opinion by order entered June 26, 1991.

OPINIONS BELOW

The opinion of the Court of Appeals for the Eighth Circuit is reported at 933 F.2d 616 and is set forth in the Appendix to this Petition ("App.") at 1a. The Order of the Court of Appeals denying rehearing is set forth in the Appendix at 42a.

The memorandum order of the United States District Court for the District of Minnesota (Alsop, C.J.) granting defendants' motion for a directed verdict at the close of plaintiffs' case, dated February 8, 1990, has not been officially reported. It is set forth in the Appendix at 13a.

JURISDICTION

The jurisdiction of this Court to review the judgment of the Eighth Circuit entered May 10, 1991, is invoked under 28 U.S.C. § 1254(1) (1988), as amended; the Petition is being timely filed within 90 days of the Eighth Circuit's June 26, 1991 denial of the defendants-appellees' timely Petition for Rehearing and Suggestion for Rehearing En Banc.

Jurisdiction in the district court was based on Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa (1988), and principles of supplemental jurisdiction. Jurisdiction in the Court of Appeals was based on 28 U.S.C. § 1291 (1988).

STATUTES AND REGULATIONS INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1988), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1991), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

STATEMENT OF THE CASE

Preliminary Statement

This petition raises the fundamental question of whether actual proof of causation is required in a private securities fraud action under Rule 10b-5. This question is presented with clarity here where, after a three week trial, the district

court granted defendants' motion for a directed verdict in light of concessions made by plaintiffs' own experts in their testimony. As the district court summarized the matter, plaintiffs' expert accounting witness identified asserted accounting errors allegedly made by defendants "but the plaintiffs' damage expert stated that no damages flowed from those improprieties." (App. 16a) Damages were alleged to have flowed from other alleged non-disclosure, "but the accounting experts did not opine that this non-disclosure was improper." (App. 16a) The district court then explained the basis for the directed verdict. (App. 16a)

> Plaintiffs' experts were therefore akin to two ships which passed in the night. There was evidence of damages, and there was evidence of improper conduct on the part of the defendants. However, the improper conduct did not cause the damage, nor were the damages produced by conduct which was classified as improper.

This petition arises from the fact that the Court of Appeals for the Eighth Circuit rejected this approach to causation as "too narrow under legal principles governing Rule 10b(5) cases." (App. 6a) The court below did not take issue with the reality of the acknowledgments made by plaintiffs' experts at trial as to the lack of a link between the proof of alleged improprieties and damages. The court nevertheless held that in a Rule 10b-5 securities fraud action where, as here, the element of reliance is established by means of the fraud-on-the-market presumption, actual proof of loss causation is also not required. If the court's opinion is taken as holding that loss causation is not an element of a Rule 10b-5 claim at all, it is in direct conflict with holdings in other circuits. If it is taken to be a determination that such an element, while required, nonetheless can be "presumed," it expands the scope of the fraud-on-the-market presumption of *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988), in a fashion contrary to the explicit understanding of at least two justices of this Court. In either event, the decision below effectively—and, it is submitted, unwisely—eliminates any requirement of actual proof

of a direct causal link between the assertedly wrongful actions of the defendant and the injury allegedly suffered by the plaintiff in a fraud-on-the-market case.

The decision below also reflects the continued confusion in the lower courts with respect to the nature of the presumption of reliance accepted by this Court in *Basic* and the circumstances under which that presumption can be rebutted. Review is warranted both to resolve the apparent conflict with the decisions of other appellate courts and, in the exercise of this Court's supervisory power, to offer guidance to the lower federal courts in the face of their widespread uncertainty as to the proper interpretation of *Basic*.

Proceedings Below

This litigation was brought by a class of individuals who purchased their shares of CDC in the open market between January 7 and August 6, 1985. They alleged that CDC and its auditors fraudulently misstated 1984 earnings in press releases and in CDC's 1984 annual report, all released before the end of the first quarter of 1985.

The litigation focused on two accounting decisions, a $16.8 million loss carryforward and a $9.7 million loss charged to retained earnings, that assertedly permitted CDC's 1984 earnings to be overstated. In July 1985, the staff of the Securities and Exchange Commission ("SEC") took issue with the accounting decisions. CDC publicly announced restatement of its financial statement on August 6, 1985, which reduced CDC's reported earnings (from $31.6 million to $5.1 million, or from $0.81 to $.12 per share). *The Wall Street Journal* reported the restatement on August 7, 1985. Plaintiffs sued the next day.[1]

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1 The district court noted at a hearing on November 8, 1985 that the complaint was based almost entirely on the August 7 *Wall Street Journal* article, stating that "I don't want to indicate to any of you that I like starting lawsuits based upon a Wall Street Journal article or that I like what I call lawyer litigation rather than client litigation." Transcript of Hearing Before the Hon. Donald D. Alsop, *Diane Abbey et al.* v. *Control Data Corp. et al.*, No. 3-85-Civil-1381, Nov. 8, 1985, at 24.

Although plaintiffs challenged the original resolution of the two accounting questions as false, fraudulent and not conforming to generally accepted accounting principles, the evidence at trial revealed that, as the Court of Appeals put it, "nothing significant happened to the stock price" following disclosure of the restated financial statements on August 6 or upon publication of the August 7 Wall Street Journal report of such restatement.[2] (App. 4a) Plaintiffs' damages expert conceded at trial that, given this fact, no damages flowed from these claimed improprieties. (App. 16a)

Plaintiffs did offer evidence at trial that CDC stock dropped in value a week *after* disclosure of the restatement, when, on August 13, *The Wall Street Journal* reported that CDC was in technical violation of certain bank loan covenants. The loan covenants were not a subject of discussion in the financial statements. The earliest technical violation with respect to the loan covenants was claimed by plaintiffs to have first occurred on March 31, 1985.[3] Moreover, prior to the last day of trial, the plaintiffs had not based the theory of their case on allegedly inadequate disclosure of loan covenant status, and the Court of Appeals upheld the district court's exclusion of such a theory when it was untimely raised. (App. 9a-11a) Plaintiffs presented no evidence that the SEC ever required or requested that CDC disclose the risk of possible future technical default under the loan covenants, and they presented *no* evidence that CDC had a duty to disclose such a risk.[4]

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2 The stock price dropped by 75 cents on August 6 and rose by 12.5 cents on August 7. As noted in the text, plaintiffs' damages expert conceded that these results did not support a claim for damages.

3 As the district court noted, plaintiffs presented no evidence that in the previous quarter, ending December 31, 1984, Control Data was even "*close* to violating its bank covenants." (App. 15a) (emphasis in original)

4 The district court excluded testimony, offered on the last day of plaintiffs' case, from an expert witness who was apparently prepared to testify that Control Data had a duty to disclose this risk of possible

Plaintiff's case as presented consisted of some evidence going to two commonly recognized substantive elements of a Rule 10b-5 claim:[5] (1) misrepresentations as to the proper accounting characterization of the loss carryforward and the charge to retained earnings and (2) scienter. Plaintiffs invoked a presumption in connection with a third element (reliance). Plaintiffs also presented some evidence that the price of CDC shares declined *a week after* the correction of the alleged misrepresentations. Plaintiffs' expert admitted, however, that this decline was unrelated to the alleged wrongful conduct with respect to the accounting treatments. (App. 15a-16a) Indeed, plaintiffs' expert conceded, in the district court's words, that "no damages flowed from those improprieties." (App. 16a) Thus, on the record before it, the district court found that plaintiffs had presented *no* evidence that the misrepresentations in question *caused* any injury. (App. 16a)

Defendants moved for a directed verdict after plaintiffs rested on this record. The district court granted the motion, holding that "[t]he flaw in plaintiffs' case comes from their inability to connect the alleged impropriety of the defendants to any damages to the shareholders." (App. 15a) The court elaborated:

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future technical default. The district court based its decision to exclude this testimony on the fact that this theory of liability had not been previously asserted in the pretrial proceedings and that plaintiffs should not be allowed to attempt to establish a new theory of liability at trial. (App. 10a) (Indeed, plaintiffs had explicitly acknowledged that their theory of the case focused on "misstatements of income"; no mention was made of loan covenants. (App. 10a)) The Eighth Circuit affirmed the district court's exclusion of this testimony on the same ground. (App. 9a-11a)

5 This Court has never undertaken to identify with precision each element of a Rule 10b-5 claim. Justice Kennedy, dissenting in *Lampf, Pleva, Lipkind, Prupis & Petrigow* v. *Gilbertson*, 111 S. Ct. 2773, 2789 (1991), stated that a Section 10(b) action "requires proof of a false or misleading statement or material omission, reliance thereon, damages caused by the wrongdoing, and scienter on the part of the defendant" (citations omitted).

> Combining the expert testimony of plaintiffs' witnesses left the court with the following scenario. The accounting experts testified that defendants' actions did not comport with generally accepted accounting principles and generally accepted auditing standards (the NOL and EESI issues), but the plaintiffs' damage expert stated that no damages flowed from those improprieties. The plaintiffs' damage expert did say that damages flowed from the defendants' non-disclosure of possible bank covenant defaults, but the accounting experts did not opine that this non-disclosure was improper. Plaintiffs' experts were therefore akin to two ships which passed in the night. There was evidence of damages, and there was evidence of improper conduct on the part of the defendants. However, the improper conduct did not cause the damage, nor were the damages produced by conduct which was classified as improper.

(App. 16a) The court directed entry of judgment for defendants. (App. 17a)

The Eighth Circuit reversed the district court's holding that plaintiffs had failed to satisfy Rule 10b-5's causation requirement and remanded for a new trial. Although recognizing that "the class had not proven that CDC had a duty to disclose the status of its loan covenants" (App. 6a) and explicitly *affirming* the district court's exclusion of a belated proffer of expert testimony on that subject (App. 11a), testimony that would have been the only evidence of any such "duty," the Eighth Circuit nevertheless held that plaintiffs had satisfied Rule 10b-5's causation requirement. "Plaintiffs are not required to meet a strict test of direct causation under Rule 10b-5; they need only show 'some causal nexus' between CDC's improper conduct and plaintiff's losses." (App. 6a)

Although alluding to proximate cause concerns as "germane," the Court of Appeals emphasized this Court's holding in *Basic* v. *Levinson*, 485 U.S. 224 (1988), in its conclusion that the district court's view of causation was "too narrow":

> This is a "fraud on the market" case. In such cases, causation is not premised on any specific transaction between plaintiff and defendant, nor is there required any proof that the plaintiff was even aware that a misrepresentation was made. Causation lies in the fact that the plaintiff relied on the market price of the security as an indicator of the future value of the stock. To the extent that the defendant's misrepresentations artificially altered the price of the stock and defrauded the market, causation is presumed. *See Basic Inc.* v. *Levinson*, 485 U.S. 224, 247 [1988] ("Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action").

(App. 6a-7a) Relying on this presumption approach to causation, the Court of Appeals held that "[t]he class presented evidence of a sufficient 'causal nexus' between CDC's improper accounting and the drop in CDC stock price, so that a reasonable jury could find causation." (App. 9a)

REASONS FOR GRANTING THE WRIT

I.

THIS COURT SHOULD RESOLVE A CONFLICT AMONG AND WITHIN THE CIRCUITS AND DETERMINE WHETHER LOSS CAUSATION IS A REQUIRED ELEMENT OF A RULE 10b-5 CLAIM AND, IF SO, WHETHER IT CAN BE PRESUMED IN A FRAUD-ON-THE-MARKET CASE

This petition presents fundamental questions as to the elements of the judicially crafted private cause of action under Rule 10b-5. Although such claims have been the subject of much litigation in the nearly half century since the private cause of action was first recognized (*see Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), cited in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 196 n.16 (1976)), this

Court has yet to address the basic question of whether proof of "causation" is required and, if so, the nature of such causation.

Most, but not all, of the Circuit Courts that have considered the matter have concluded that proof of some form of causation is an essential element of a Rule 10b-5 claim. But as Circuit Judge Posner wrote recently in *Bastian* v. *Petren Resources Corp.*, 892 F.2d 680, 685 (7th Cir.), *cert. denied*, 110 S. Ct. 2590 (1990), an opinion explicitly adopting the loss causation requirement in the Seventh Circuit, the requirement is not universal.

> We have treated the question whether loss causation is an element of a claim for damages under Rule 10b-5 from the ground up because there is no controlling precedent in the Supreme Court or in this circuit, and because there are cases on both sides of the question in the other circuits, though they greatly preponderate in favor of the requirement and such conflict as there is appears to be within rather than among circuits. Compare *Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-81 (2d Cir. 1974); *Huddleston* v. *Herman & MacLean*, 640 F.2d 534, 549-50 (5th Cir.), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375, 103 S. Ct. 683, 74 L. Ed. 2d 548 (1983); *Bennett* v. *United States Trust Co.*, 770 F.2d 308, 313-14 (2d Cir. 1985), and *Currie* v. *Cayman Resources Corp.*, 835 F.2d 780, 785 (11th Cir. 1988), with *Marbury Management, Inc.* v. *Kohn*, 629 F.2d 705, 708-10 (2d Cir. 1980), and *Bruschi* v. *Brown*, 876 F.2d 1526, 1530-31 (11th Cir. 1989).

In part, the conflict Judge Posner rightly observes stems from confusion between "transaction causation" and "loss causation." "Transaction causation, another way of describing reliance, is established when the misrepresentations or omissions cause the plaintiff 'to engage in the transaction in question.' " *Currie* v. *Cayman Resources Corp.*, 835 F.2d 780, 785 (11th Cir. 1988), quoting *Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974), *cert.*

denied, 421 U.S. 976 (1975). It focuses on the causal relationship between the defendant's conduct and the transaction with the plaintiff, *not* on the link between the defendant's conduct and the loss. It "is nothing more than 'but for' causation, which is merely another way of describing reliance." *Harris* v. *Union Electric Co.*, 787 F.2d 355, 366 (8th Cir. 1986), *cert. denied*, 479 U.S. 823 (1986); *Wilson* v. *Ruffa & Hanover, P.C.*, 844 F.2d 81, 86 (2d Cir. 1988) ("[t]ransaction causation, of course, is simply reliance"), *vacated and aff'd on other grounds*, 872 F.2d 1124 (2d Cir. 1989).

Loss causation, on the other hand, establishes "that the misrepresentations or omissions caused the economic harm." *Schlick* v. *Penn-Dixie Cement Corp.*, *supra*, 507 F.2d at 380. *See also Bastian* v. *Petren Resources*, *supra*, 892 F.2d at 685; *Currie* v. *Cayman Resources Corp.*, *supra*, 835 F.2d at 785. In the words of the Fifth Circuit, " 'loss causation' refers to a direct causal link between the misstatement and the claimant's economic loss." *Huddleston* v. *Herman & MacLean*, *supra*, 640 F.2d 534, 549 n.24 (5th Cir. 1983), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983).[6]

The Eighth Circuit's opinion in this case requires no more than the "but for" causation of transaction causation. After raising the concept of "fraud on the market," a concept of reliance that was not contested on appeal, the Court of

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6 The Fifth Circuit in *Huddleston* offered the following illustration of the difference between transaction causation and loss causation.

> [A]n investor might purchase stock in a shipping venture involving a single vessel in reliance on a misrepresentation that the vessel had a certain capacity when in fact it had less capacity than was represented in the prospectus. However, the prospectus does disclose truthfully that the vessel will not be insured. One week after the investment the vessel sinks as the result of a casualty and the stock becomes worthless.

Huddleston v. *Herman & MacLean*, *supra*, 640 F.2d at 549 n.25. In this hypothetical, the investor may be able to prove transaction causation—he or she presumably would not have bought the stock "but for" the misrepresentation. But the investor will not be able to prove loss causation—because the misrepresentation did not cause the loss.

Appeals properly recognized that in such cases, "causation is not premised on any specific *transaction*." (App. 6a) (emphasis added). The court went on, however, to extrapolate that in such cases *causation* is also presumed: "*causation* lies in the fact that the plaintiff *relied* on the market price of the security as an indicator of the future value of the stock" and it held that "[t]o the extent that the defendant's misrepresentations artificially altered the price of the stock and defrauded the market, *causation is presumed. See Basic Inc.* v. *Levinson*, 485 U.S. 224, 247 [1988]." (App. 7a) (emphasis added)[7] Thus it is plain that the Eighth Circuit (1) equated "causation" with reliance and (2) concluded that causation, like reliance, could be presumed in fraud-on-the-market cases under *Basic*.

To the extent the opinion below is read to dispense with the element of "loss causation" altogether, it is in conflict with the Seventh Circuit opinion in *Bastian* v. *Petren Resources* and the cases cited therein. In light of Eighth Circuit decisions recognizing the loss causation requirement prior to[8] and subsequent to[9] the present one, the opinion might also be read not to reject loss causation altogether but simply to equate such "causation" with "reliance" and to allow each element to be satisfied by the same presumption in fraud-on-the-market cases. That reading would still eliminate altogether any requirement of actual proof of loss causation in fraud-on-the-market cases. (This latter approach is followed by the Eighth Circuit—in conflict with other circuits—in other securities fraud cases where reliance is presumed.)[10]

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7 Significantly, the opinion did not require that the allegedly actionable misrepresentation itself caused a change in the market.

8 *Harris* v. *Union Electric Co.*, 787 F.2d 355, 366 (8th Cir.), *cert. denied*, 479 U.S. 823 (1986).

9 *Arthur Young & Co.* v. *Reves*, 937 F.2d 1310, 1332 (8th Cir. 1991).

10 The interpretation of *Basic* adopted by the court below is at odds with the understanding of the Second Circuit and other lower federal courts of the scope of the rebuttable presumption of reliance under

In following this approach, the Court of Appeals treats as subject to satisfaction by a single presumption two elements which other courts have viewed as analytically distinct.[11] The effect on this case is plain: it allows the court to gloss over the acknowledgment by plaintiffs' own expert that there is no link between the alleged improprieties and damages. Instead, a jury is to be permitted to speculate generally as to any "causal nexus" between improper accounting and any subsequent drop in stock price, even in the acknowledged absence of any evidence of such link.

Rule 10b-5 established by this Court in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 153-54 (1972) (reliance presumed where omitted fact is material). These courts have held that the *Affiliated Ute* reliance presumption establishes only transaction causation and that loss causation must still be proven separately. *Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374, 381 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); *Hartman* v. *Blinder*, 687 F. Supp. 938, 943 (D.N.J. 1987). *See also Huddleston* v. *Herman & MacLean*, *supra*, 640 F.2d at 549 (even were *Affiliated Ute* presumption available, causation would still be a matter of individualized proof). The Eighth Circuit has, with respect to the *Ute* presumption as well as that of *Basic*, apparently concluded that the presumption of reliance eliminates the need for actual proof of loss causation. *See Harris* v. *Union Electric Co.*, *supra*, 787 F.2d at 366-67; Kaufman, *Loss Causation: Exposing a Fraud on Securities Law Jurisprudence*, 24 Ind. L. Rev. 357 n.8 (1991) (*Harris* "suggest[s] that both transaction and loss causation can be inferred from the materiality of the nondisclosures"). Thus, in this respect, the Eighth Circuit appears to be in conflict with the Second Circuit's decision in *Schlick* (holding that actual proof of loss causation is required even where reliance may be presumed). More generally, it appears from this series of cases that the Eighth Circuit treats securities fraud cases involving a presumption of reliance differently from all other securities fraud cases even as to matters beyond the element of reliance itself.

11 This Court has resisted efforts in other areas of the law to weaken the need for proof of one element of a claim simply because a presumption or other procedural shortcut is available as to a different element. *See, e.g., Atlantic Richfield Co.* v. *USA Petroleum Co.*, 110 S. Ct. 1884, 1893 (1990) (rejecting "suggestion that no antitrust injury need be shown where a *per se* violation is involved").

More generally, if loss causation may be presumed in fraud-on-the-market cases, all a plaintiff needs to prove in such cases is (1) some material misrepresentation or omission and (2) some later drop in the price of the security. Under the Eighth Circuit's decision, both reliance (or transaction causation) and loss causation would be presumed under this Court's plurality (4-2) decision in *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988).

This reading may perhaps have literally been left open by some language in the four-justice plurality opinion. *See Basic Inc.* v. *Levinson*, *supra*, 485 U.S. at 243 ("[r]eliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury"); Note, *Basic Inc.* v. *Levinson: An Unwise Extension of the Fraud-On-The-Market Theory*, 67 N.C.L. Rev. 1161, 1168 (1989) (hereinafter, "Note, *Fraud-On-The-Market*") ("[t]he Court's opinion in *Basic* is open to the interpretation that plaintiffs can rely on the fraud-on-the-market theory to satisfy their burden of proving loss causation").

But this reading is, we submit, a dangerous and unwise interpretation and extension of this Court's initial discussion of the fraud on the market theory and is at odds with the understanding of at least two members of the Court.[12] *See Basic Inc.* v. *Levinson*, *supra*, 485 U.S. at 251 (White, J.,

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12 The inappropriateness of reading this Court's opinion in *Basic* as addressing the issue of loss causation is suggested not only by Justice White's comments (quoted in the text), but by the fact that the plurality opinion expressly declined to address "the proper measure of damages in litigation of this kind." 485 U.S. at 248 n.28. *See also* 485 U.S. at 254 n.5 (White, J., dissenting) ("the difficult damages question is one the Court expressly declines to address today"). But a presumption of loss causation *is* a presumption about damages. *See* Note, *Fraud-On-The-Market*, *supra*, 67 N.C.L. Rev. at 1168 ("[transaction causation] is a question of reliance, which can be supplied by the fraud-on-the-market theory, while [loss causation] is a completely different question concerning proof of damages." *See also* T. Hazen, *Securities Regulation* § 13.6 at 103 (1990) ("recent loss causation cases define loss causation narrowly, in terms of a need to identify that portion of the loss which can be traced to the material misrepresentation or omission").

joined by O'Connor, J., concurring in part and dissenting in part) ("[m]ost importantly, the [plurality opinion] rejects the version of [the fraud-on-the-market] theory, heretofore adopted by some courts, which equates 'causation' with 'reliance' ").[13]

Without the requirement of actual proof of causation, "Rule 10b-5 would become an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission." *Huddleston* v. *Herman & MacLean*, *supra*, 640 F.2d at 549; *see also Marbury Management Inc.* v. *Kohn*, *supra*, 629 F.2d 705, 718 (2d Cir. 1980) (Meskill, J., dissenting) (requiring proof of transaction causation alone would convert maker of a misrepresentation into "an insurer of the investment, responsible for an indefinite period of time for any and all manner of unforeseen difficulties which may eventually beset the stock"), *cert. denied*, 449 U.S. 1011 (1980). This radical expansion of the judicially crafted Rule

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13 At least one circuit court, in a pre-*Basic* case, had taken the approach of the decision below of presuming causation along with reliance in fraud-on-the-market cases. The Third Circuit expressly presumed both transaction causation and loss causation in such cases. *Peil* v. *Speiser*, 806 F.2d 1154, 1160-63 (3d Cir. 1986). As interpreted by a district court after *Basic*, the decision in *Peil* "presumes reliance, both transaction causation and loss causation, so long as the [p]laintiffs can prove that the misrepresentation or omission was both material and that it was disseminated in a well developed and open market transaction." *In re Phillips Petroleum Securities Litigation*, 738 F. Supp. 825, 835 (D. Del. 1990).

The district court in *Bastian* v. *Petren Resources Corp.*, 682 F. Supp. 956 (N.D. Ill. 1988), in one of the series of decisions affirmed by the Seventh Circuit per Judge Posner in the opinion discussed above, expressly rejected this approach. In an earlier decision, the district court had dismissed plaintiffs' Rule 10b-5 claim for failure to plead loss causation prior to this Court's decision in *Basic*. 681 F. Supp. 530, 532-36 (N.D. Ill. 1988). Plaintiffs moved for reconsideration following *Basic*, arguing that *Basic* allows for a presumption of both transaction causation and loss causation. 682 F. Supp. at 956-57. The district court rejected this reading of *Basic*, holding that the *Basic* presumption extends only to transaction causation. *Id.* at 957. The Seventh Circuit affirmed the district court's subsequent dismissal of the amended complaint without expressly discussing this issue. 892 F.2d 680.

10b-5 liability is not warranted: "No social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda with a fine-tooth comb in the hope of uncovering a misrepresentation." *Bastian* v. *Petren Resources Corp.*, *supra*, 892 F.2d at 685.

An expansion of the *Basic* presumption of reliance to include a presumption of loss causation would have the effect of eliminating the obligation to demonstrate that an actionable misrepresentation directly caused plaintiffs' losses. It would, as here, allow recovery by plaintiffs in the face of their own experts' acknowledgment that no link existed between the only conduct identified at trial as wrongful and the alleged damages.

Such an approach expands Rule 10b-5 liability essentially as if causation were not a required element of a Rule 10b-5 claim at all. It permits recovery where a plaintiff establishes a misrepresentation and reliance on the market even if his loss (or that of his class) is in no way attributable to the misrepresentation. This invitation to expanded Rule 10b-5 liability, an invitation rejected by several other circuits, warrants review.

II.

THIS COURT, TO CORRECT A DEPARTURE FROM ITS PRECEDENT AND IN THE EXERCISE OF ITS SUPERVISORY POWER, SHOULD CLARIFY WHETHER AND HOW THE FRAUD-ON-THE-MARKET PRESUMPTION OF RELIANCE MAY BE REBUTTED

This Court held in *Basic* that "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance." *Basic Inc.* v. *Levinson*, *supra*, 485 U.S. at 248. But Justice White, joined by Justice O'Connor, dissenting, noted that

> in practice the Court must realize, as other courts applying the fraud-on-the-market theory have, that such rebuttal is virtually impossible in all but the most extraordinary case. *See Blackie* v. *Barrack*, 524 F.2d [891], 906-07, n.22 [(9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1978)]; *In re LTV Securities Litigation*, 88 F.R.D. 134, 143 n.4 (N.D. Tex. 1980).

Basic Inc. v. *Levinson*, *supra*, 485 U.S. at 256 n.7.

The decision below demonstrates that Justice White was, if anything, unduly sanguine. This case, in which disclosure of the asserted misrepresentations failed to affect the market price of the security in question, would seem to be "the most extraordinary case." Plaintiffs' expert conceded that the misrepresentation on which plaintiffs relied did *not* inflate the price of the security since public disclosure of the purported misrepresentation wholly failed to deflate that price. It would seem that this case satisfies this Court's paradigm of rebuttal, where the evidence shows "that the misrepresentation in fact did not lead to a distortion in price." 108 S. Ct. 992. Yet the Eighth Circuit here found the fraud-on-the-market theory sufficient to sustain not only the reliance element but the causation element as well.

The apparent departure of the court below from the controlling precedent of this Court is significant in itself. It is also symptomatic of a wider problem: the lower federal courts are uncertain about both the scope of the *Basic* presumption and how it may be rebutted. *See, e.g.*, *Moskowitz* v. *Lopp*, 128 F.R.D. 624, 631 (E.D. Pa. 1989); *In re LTV Securities Litigation*, 88 F.R.D. 134, 143 n.4 (N.D. Tex. 1980) (both holding fraud-on-the-market presumption to be effectively nonrebuttable). *See also* Note, *Fraud-On-The-Market Theory After Basic Inc.* v. *Levinson*, 74 Corn. L. Rev. 964, 991 (1989) ("[t]he different applications of the fraud-on-the-market theory have led to confusion among the courts, confusion which requires swift and pragmatic resolution"); Macey & Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-On-The-Market Theory*, 42 Stan. L.

Rev. 1059, 1061 (1990) ("[t]he Court's failure to articulate the theoretical underpinnings of its opinion [in *Basic*] will make the task of applying the decision difficult for lower courts"); Cornell & Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 U.C.L.A. L. Rev. 883, 915 (1990) ("the burden of proving damages is clearly one of the 'confusions and contradictions' that Justice White foresaw in *Basic*"). Given the volume and complexity of Rule 10b-5 litigation, this Court should, in the exercise of its supervisory authority and to correct a departure from its own controlling decision, revisit the fraud-on-the-market presumption in order to offer much needed additional guidance as to the circumstances under which the presumption may be rebutted.

CONCLUSION

For the foregoing reasons the petition for a writ of *certiorari* should be granted.

Dated: New York, New York
September 24, 1991

Respectfully submitted,

STEVEN J. OLSON
A. REID SHAW
Control Data Corporation

Attorneys for Control Data Corporation

CRAIG W. GAGNON
MICHAEL J. BLECK
OPPENHEIMER WOLFF & DONNELLY

Attorneys for Individual Petitioners

*Counsel of Record

*DEAN I. RINGEL
ADAM LIPTAK
CAHILL GORDON & REINDEL
(a partnership including a professional corporation)
80 Pine Street
New York, New York 10005
(212) 701-3000

Attorneys for Petitioners

ELLIOT S. KAPLAN
DEBORAH J. PALMER
ROBINS, KAPLAN, MILLER & CIRESI

PHILIP A. BROWN
VORYS, SATER, SEYMOUR AND PEASE

LEONARD P. NOVELLO
General Counsel
EDWIN D. SCOTT
Associate General Counsel
KPMG PEAT MARWICK

Attorneys for KPMG Peat Marwick

APPENDIX

UNITED STATES COURT OF APPEALS

FOR THE EIGHTH CIRCUIT

No. 90-5107

Submitted: November 15, 1990

Filed: May 10, 1991

IN RE: CONTROL DATA CORPORATION SECURITIES LITIGATION

DIANE ABBEY, DAVID WEISGAL, WILLIAM STEINER, WILLIAM RANDALL, and JOHN PAGE,

Appellants,

—v.—

CONTROL DATA CORPORATION, NORBERT R. BERG, WILLIAM C. NORRIS, ROBERT M. PRICE, MARVIN G. ROGERS, and PEAT, MARWICK, MAIN & CO.,

Appellees.

Appeal from the United States District Court for the District of Minnesota.

Before:

LAY, *Chief Judge*, FAGG, *Circuit Judge*, and WRIGHT,* *District Judge*.

* The HONORABLE SUSAN W. WRIGHT, United States District Judge for the Eastern District of Arkansas, sitting by designation.

LAY, *Chief Judge.*

In a class action, plaintiffs represent approximately 10,000 persons who purchased Control Data Corporation stock between January 7 and August 6, 1985. The complaint alleges that Control Data, its officers, and auditor (Peat Marwick) disseminated information misrepresenting the financial health of the company in violation of Section 10(b) of the Securities and Exchange Act of 1934 (Rule 10b-5). The district court[1] directed a verdict for defendants, ruling that the class failed to prove the alleged misrepresentations caused damages to the class. Plaintiffs appeal. We affirm in part, reverse in part, and remand for trial.

I.

Plaintiffs allege Control Data Corporation (CDC) made several public statements that materially misrepresented the company's financial status in violation of Rule 10b-5. On January 4, 1985, CDC issued a press release announcing 1984 earnings at 80 cents a share and expected 1985 earnings at $4 a share. CDC made similar statements in a January 23, 1985, press release and in its 1984 Annual Report and Form 10-K. The Annual Report was very optimistic and projected "substantially increased earnings in 1985." [A.33].

Plaintiffs claim that CDC made two accounting decisions that inflated income and made these reported earnings figures higher than CDC's true earnings and projections. They allege that CDC knew its financial health was deteriorating and made these improper accounting maneuvers to avoid public disclosure of its financial problems. The class contends that Peat-Marwick allowed the accounting maneuvers knowing they were improper.[2]

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1 The Honorable Donald D. Alsop, Chief United States District Judge for the District of Minnesota.

2 Although Peat-Marwick challenges its liability on the separate ground relating to its duty to disclose known misrepresentations, it does not

In July, 1985, the Securities and Exchange Commission (SEC) informed CDC that the two accounting decisions were improper.[3] After attempting to convince the SEC of the propriety of the accounting decisions, CDC ceased opposition and on August 6, 1985, announced a restatement of its earnings. This restatement had the effect of reducing 1984 earnings by 84%. Control Data's reported net income was reduced from $31.6 million to $5.1 million and per share earnings dropped from $0.81 to $0.12. No significant change in stock price occurred on the day of the restatement, but after the Wall Street Journal reported on August 13, 1985 that reversal of the accounting decisions also meant that CDC had defaulted on its loan covenants, CDC stock immediately dropped $3 per share in high volume. The class argues that, had CDC publicized its true financial condition by not making the accounting maneuvers, the class would not have purchased CDC stock at its inflated value and would not have suffered the $3 per share loss.

After four years of discovery, the case went to trial in January, 1990. Plaintiff's case lasted three weeks, and at its end all defendants moved for a directed verdict. The court found sufficient evidence that CDC's accounting procedures were improper, but found no evidence of damages resulting from these violations. In contrast, the court found the losses the class suffered due to the drop in stock price resulted from CDC's failure to disclose its possible loan convenant defaults. The court, however, found no evidence that such disclosure was required. Accordingly, the court directed a verdict for defendants.

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list the issue of its separate liability in the statement of issues in its brief. Undoubtedly this is because the district court did not address that issue, as it based its decision on the plaintiffs' failure to prove causation. Because a remand is in order we do not address the separate issue of auditor liability, and the parties are free to confront the district court on this issue.

3 The improper accounting procedures concerned (1) carrying forward a $16.8 million net operating loss tax benefit and (2) charging a $9.7 million loss incurred by an affiliate to retained earnings.

II.

Although the text of Rule 10b-5[4] does not directly require proof of scienter, causation, or damages, it is settled that these are essential elements of a Rule 10b-5 claim. *See Harris v. Union Elec. Co.*, 787 F.2d 355, 362 (8th Cir.), *cert. denied*, 479 U.S. 823 (1986).

The district court found the class presented a submissible case on all elements except causation. The difficulty in the case arose from the fact that the class premised liability on CDC's misleading income statements, alleging that class members bought CDC stock at inflated prices based on the effect the misrepresentations had on the market price. However, when CDC corrected its error and restated its earnings, nothing significant happened to the stock price. Presumably, if the incorrect income figures inflated CDC's stock price, correcting the earnings figures should have deflated the price, and the amount the stock dropped in price would be the measure of damages. *See Harris v. Americans Inv. Co.*, 523 F.2d 220, 226-27 (8th Cir. 1975) (measure of damages generally is fixed as of the date the investing public becomes aware of the fraud), *cert. denied*, 423 U.S. 1054 (1975). Given no drop in price immediately after the restatement, plaintiff's expert on damages, John Torkelson, stated that the restatement of earnings caused no damages.

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4 Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase of any security.

17 C.F.R. § 240.10b-5 (1987).

The district court found this testimony fatal to the plaintiff's case. The court, seeking to define the parameters of the case and limit the issues before trial, focused on the restatement of earnings as the basis of liability and understood the case to be a "restatement case". Although the class in its complaint and contention interrogatories alleged that CDC committed a variety of misrepresentations,[5] counsel for the class had acknowledged in a pre-trial hearing that the class would pursue only the misrepresentations resulting from CDC's improper accounting.[6] Thus, the court found that

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5 The class sought relief based on Rule 10b-5, common law fraud, and negligent misrepresentation. The Consolidated Complaint emphasized CDC's two improper accounting decisions reflected in the 1984 Annual Report and Form 10-K as the primary misrepresentations. [A.30-32, 41-45] However, the complaint also alleged that CDC officers made misleading optimistic statements about prospects for future earnings and fraudulently increased dividends to perpetuate a falsely rosy financial picture. [A.33-34] CDC allegedly also failed to report substantial losses. [A.34-35] CDC's announcement that it was granted temporary waivers on its revolving credit agreement also was listed as a "substantive allegation". [A.37]

In answer to contention interrogatories, the class reiterated the liability claims in the complaint and further asserted that the 1984 Annual Report, Form 10-K, and Form 10-Q were misleading as a whole because they failed to represent CDC's true financial condition. [A.50] The class listed 21 specific statements from these documents that allegedly were untrue. [A.50-59] The class also listed statements made by CDC officers at an investment community meeting, alleging that the statements were misleading for failing to disclose, inter alia, that CDC was close to default on its revolving loan covenants. [A.59-62] The class also listed a January 4, 1985 press release as misleading. [A.62]

6 The following colloquy took place:

> The Court: [M]y writing or my pretrial order says the gravamen of the plaintiff's complaint concerns alleged misstatements of income contained in the '84 Annual Report, Form 10X, and an interim report for the first half of '85; which correspond in a general way with the Control Data designation of issues . . .
>
> . . .
>
> What is your perception as to whether those are in fact the issues in this lawsuit?

(*footnote continued*)

Torkelson's testimony foreclosed recovery on plaintiff's sole theory of liability.

A further consideration, however, was that CDC's stock price did drop significantly a week after the restatement, after the Wall Street Journal reported that, as a result of the restatement, CDC was in default on its loan covenants, retroactive to March 31, 1985.[7] The class relied on this drop in the stock price as its measure of damages. The court, however, held that the drop in value of CDC stock was not caused by CDC's restatement of earnings, but instead was due to CDC's failure to disclose the status of its loan covenants. Because the class had not proven that CDC had a duty to disclose the status of its loan covenants, the district court reasoned that damages were not caused by CDC's wrongful conduct.

We find the district court's view of causation too narrow under legal principles governing Rule 10b(5) cases. Plaintiffs are not required to meet a strict test of direct causation under Rule 10b-5; they need only show "some causal nexus" between CDC's improper conduct and plaintiff's losses. *Union Elec.*, 787 F.2d at 366; *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040, 1048 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978). Traditional tests of proximate cause derived from tort principles are very much germane. *See, e.g., Marbury Mgmt. Inc. v. Kohn*, 629 F.2d 705, 708 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980).

This is a "fraud on the market" case. In such cases, causation is not premised on any specific transaction between plaintiff and defendant, nor is there required any proof that

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Mr. Cambronne (Plaintiff's Counsel): Your Honor, I am pleased to say that the outline of issues as reflected in the Control Data brief is accurate.

[A.1279-80]

7 CDC was required to maintain minimum levels of net worth and debt-equity ratios under its revolving credit agreements. Using the restated earnings figures, CDC was in violation of its loan covenants as of March 31, 1985. *Dist. Ct. Order* at 5.

the plaintiff was even aware that a misrepresentation was made. Causation lies in the fact that the plaintiff relied on the market price of the security as an indicator of the future value of the stock. To the extent that the defendant's misrepresentations artificially altered the price of the stock and defrauded the market, causation is presumed. *See Basic Inc. v. Levinson*, 485 U.S. 224, 247 (1987) ("Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action").

A jury could reasonably find that CDC's improper accounting artificially altered the price of CDC stock in a variety of ways. Perhaps most obviously the improper accounting inflated 1984 actual earnings and 1985 projected earnings, figures that investors may have considered important in making investment decisions.[8] However, the improper accounting also altered CDC's true net worth and debt-equity ratio. Plaintiffs' expert testified that these figures are financial indicators that would be important to investors because of what they reveal about the status of CDC's loan covenants.[9]

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8 There was testimony in the record, however, suggesting that investors would place little value in "historical" figures of earnings, because investors are concerned only with future performance of the company. Plaintiff's expert Torkelson opined:

> Basically the restatement [of earnings] itself, the numbers are a restatement of the past and would not be interpreted by themselves by a reasonable analyst as affecting the future of the company, and the stock price reflects the future of the company. Instead, the importance of these numbers [is] the fact that by removing these figures from the net worth of the company, the company then fell into a default situation with its lenders which did create an operational problem for the company and is important to an [investment] analyst. So it's the relationship between the company and its lenders that's important to the financial community. And to the extent that [the defendant's concealed] that relationship; that is, the default relationship, through the use of accounting adjustments, that is what is the problem from the point of view of the financial community and the value of the stock.

[A.1327]; *see also* [A.416]

9 *See supra* note 8.

CDC is liable for damages resulting from *any* reasonable investment actions taken in mistaken reliance on its misrepresentations. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972). The fact that the misrepresented earnings figures did not affect the stock price does not negate the possibility that investors were misled in other ways by the improper accounting maneuvers. Thus, CDC would be liable if its improper accounting concealed the company's net worth and debt-equity ratio and inflated the price of CDC stock by obscuring the company's risk of default on its loan covenants.[10]

There is no basis for limiting the class to relief only for damages accruing from the effect CDC's improper accounting had on the reported earnings figures. Although termed a "restatement case" by the district court, the class did nothing to limit its claim solely to damages caused by misrepresented earnings figures. It is difficult in our minds to say that the inflated earnings statement was not inextricably tied to the same improper accounting procedures that concealed the risk of loan default.[11]

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10 The parties dispute whether the plaintiffs need to show that the accounting maneuvers obscured CDC's actual default on its loan covenants or only that the improper accounting concealed CDC's risk of loan default. The crux of the issue is whether the improper conduct artificially affected the market price of the stock. *Union Elec.*, 787 F.2d at 367 n.9. This depends on whether a reasonable investor might have considered either actual default or the risk of actual default important in the investment decision. *Affiliated Ute Citizens*, 406 U.S. at 153-54. There was expert testimony in the record indicating that disclosure of the risk of loan default would be important to investors. Thus, the plaintiffs should be allowed to test that claim before a jury.

11 Under Fed. R. Civ P. 16(e), each party is bound to its statement of issues as reflected in the pre-trial order. *Glismann v. AT&T Technologies, Inc.*, 827 F.2d 262, 267 (8th Cir. 1987). Although the class stated at a pre-trial hearing that its case was limited to the accounting issues in the 1984 Annual Report, Form 10-K and 1985 interim report, there is no suggestion in the record that the case was limited only to the accounting issues as they affected the earnings figures. Plaintiff's counsel agreed with the district court's statement that "the gravamen of the plaintiff's complaint concerns alleged misstatements of income." [A.1279-80] However, income and earn-

Determination of whether a misrepresentation would have the effect of defrauding the market and inflating the stock price is a jury question. The trier of fact is uniquely competent to determine materiality, as that inquiry requires "delicate assessments of inferences a [reasonable investor] would draw from a given set of facts." *TSC Indus.*, 426 U.S. at 450. The class presented evidence of a sufficient "causal nexus" between CDC's improper accounting and the drop in CDC stock price, so that a reasonable jury could find causation. *See Union Elec.*, 787 F.2d at 366. Accordingly, we find the district court erred in directing a verdict for defendants, and remand the proceeding for a plenary trial.

III.

A.

The class contests the district court's decision precluding its witness, Mr. Ten Eyck, from testifying that CDC had a duty to disclose in its 1984 Annual Report that the company could not borrow the full amount committed to it under two revolving credit agreements because such action would cause it to default on its loan covenants. The class offered Mr. Ten Eyck's testimony to rebut the testimony of a Peat Marwick officer, who stated he had never seen a company disclose that it was in risk of default on a loan covenant. More significantly, the class intended to use Mr. Ten Eyck's testimony to establish a second basis of liability; that aside from CDC's failure to use proper accounting standards, CDC violated its duty to disclose the status of its loan covenants. The district court excluded the testimony, finding the claim outside the scope of the case.

Review of the record indicates that the class had not previously asserted in its complaint or elsewhere that CDC had a

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ings are not synonymous. By stating that the case was limited to CDC's misstatement of income, the class did not signify that its case was limited only to the effects of the misstated income as if affected earnings. Thus, the class was free to show that the misstatements of income affected CDC's stated net worth and debt-equity ratio as well as its reported earnings figures.

duty to disclose its risk of loan default.[12] Thus, the class was attempting to establish a new theory of liability at trial.

Rule 16 of the Federal Rules of Civil Procedure imposes a duty on each party to assist the court in defining the issues for trial. *Erff v. MarkHon Indus., Inc.*, 781 F.2d 613, 617 (7th Cir. 1986) ("Attorneys at a pre-trial conference must make a full and fair disclosure of their views as to what the real issues at trial will be."). Rule 16(c)(1) directs the parties to formulate and simplify the issues "in the hope of promoting efficiency and conserving judicial resources by identifying the real issues prior to trial, thereby saving time and expense for everyone." Fed. R. Civ. P. 16 advisory committee notes, subd. c (1983).

The court established at pre-trial, with the concurrence of the plaintiffs, that the sole theory of liability in the case was based on CDC's alleged misstatements of income. This pre-trial order "controls the subsequent course of the action, unless modified at the trial to prevent manifest injustice." Fed. R. Civ. P. 16(e). Consequently, "a party may not offer evidence or advance theories which violate the terms of a pre-trial order." *Glismann v. AT&T Technologies*, 827 F.2d 262, 267 (8th Cir. 1987); *see also Hale v. Firestone Tire & Rubber Co.*, 756 F.2d 1322, 1335 (8th Cir. 1985).

The class is bound by the pre-trial order and we find no evidence of manifest injustice relief from the order. After four years of discovery, the class should have been fully aware of the viable claims it could pursue. An additional concern is the injustice and prejudice to the defendants, and this court has held that "a pre-trial order will be modified only if there is no substantial injury or prejudice to the opponent." *Hale*, 756 F.2d at 1335. The defendants rightly claimed prejudice from "surprise" testimony offered on the last day of the plaintiff's case. Although this prejudice might

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12 The class did refer to CDC's risk of loan defaults in its contention interrogatories, in which it alleged that CDC officials made misleading statements at investment meetings concerning the general financial health of the company. [A.60] However, the class never asserted a separate duty to disclose the loan defaults, and it did not pursue the alleged oral misrepresentations at trial.

have been relieved by granting a continuance, *see* Fed. R. Civ. P. 15(b), the district court did not abuse its discretion in excluding the testimony.

IV.

Plaintiff's final claim of error involves the cut-off date for determining damages. When defendants moved for summary judgment the court denied the motions but held that it would consider evidence of damages up to, but no later than, August 13, 1985. [A.192-93] The court reasoned that by August 13 the restatement had been made and "the world knew that there were at least technical defaults in the loan conditions." [A.193] Plaintiffs argued that damages should be measured as of September 20, 1985, the next trading day after CDC cancelled its scheduled public offering of stock and the world knew the full extent of CDC's financial decline. The price of CDC stock dropped significantly on September 20.

In securities fraud cases involving publicly traded stock, damages typically are determined as of the date the fraud is discovered. *American Inv.*, 523 F.2d at 225-27. Determining the date the fraud is discovered is a question of fact, but the court may decide the question as a matter of law if there is no valid factual dispute. *Holloway v. Pigman*, 884 F.2d 365, 366 (8th Cir. 1989).

The district court stated that it precluded evidence of damages after August 13, 1985, because it had "never understood [the case] to be about the public offering." [A.192] The court correctly observed that any drop in stock price due to the failure of the public offering would not be recoverable as damages, because plaintiffs never sought damages as a result of CDC's failure to successfully complete a public offering. Nor did the class allege that any of the financial disclosures that accompanied the cancellation of the public offering related to its allegations of accounting impropriety. The class claims that financial information disclosed on September 17

relates only to its nonaccounting allegations. *Appellant's Brief* at 44.

As noted above, the class originally alleged that, separate from its accounting violations, CDC officers made misleading statements to investors and failed to disclose material information. Prior to trial, however, counsel for the class acknowledged that the case was limited to accounting issues.[13] Thus, the class has effectively conceded that any damages it incurred after August 13 relate only to issues not in the case. To avoid summary judgment, a party must show a factual dispute regarding a *viable* issue. *Holloway*, 884 F.2d at 365. We cannot fault the district court for precluding recovery on claims the class had abandoned. The court's ruling limiting proof of damages is affirmed.

We remand to the district court for proceedings consistent with this opinion.

A true copy.

Attest:

CLERK, U.S. COURT OF APPEALS, EIGHTH CIRCUIT.

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13 *See supra* note 6.

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
THIRD DIVISION

3-85 CIV 1341, 3-85 CIV 1389, 3-85 CIV 1491, 3-85 CIV 1572, 3-85 CIV 1645, 3-85 CIV 1855

IN RE: CONTROL DATA CORPORATION SECURITIES LITIGATION

MEMORANDUM ORDER

This lawsuit began shortly after Control Data Corporation ("CDC") restated its 1984 financial statements on August 6, 1985. At least one plaintiff filed suit as early as August 8, alleging violations of the Securities Exchange Act and Rule 10b-5. Numerous other plaintiffs also filed such actions and class certification was granted on December 1, 1986.

On January 16, 1990 the action came before the court for trial by jury. On February 5, 1990, plaintiffs completed presentation of their case and rested. All defendants then moved from directed verdicts. The court granted those motions, noting that a written memorandum and order would follow.

In order to prevail under 15 U.S.C. §§ 78j(b) and 78t(a) and Rule 10b-5 of the Securities and Exchange Commission, the plaintiffs had to prove several elements:

1. That the defendants used the mails or instrumentalities of interstate commerce in connection with the sale or purchase of a security.

2. That the defendants made false or misleading statements of fact, or failed to state facts necessary to make the statements made by them not misleading under the circumstances.

3. That the defendants acted with scienter in making, or omitting to make, those representations.

4. That the plaintiffs in some way relied on those statements.

5. That the plaintiffs suffered losses as a result of a defendant's misstatements or omissions.

Defendants based their directed verdict motions principally on two grounds. First, that plaintiffs failed to prove scienter on the part of the defendants. Second, that no damage flowed from any claimed improprieties on the part of the defendants. The court granted the defendants' motions only on the second ground. As to the scienter element, as well as to all other elements, there was evidence sufficient to allow the case to go to the jury.

From this case's inception, the allegations of fraud dealt with the 1984 financial statements of CDC and statements by CDC relating to the 1984 and 1985 performance of the company. Specifically, in the 1984 financial statements, CDC included as an asset a net operating loss carryforward tax benefit ("NOL") of $16.8 million and accounted for prior years losses to its Earth Energy Systems, Inc. ("EESI") affiliate with a direct charge of $9.7 million to retained earnings. After later correspondence with the Securities and Exchange Commission ("SEC"), CDC restated its financial statements, foregoing the NOL benefit and charging the EESI losses to its 1984 earnings. This had the effect of lowering CDC's 1984 income from $.81 per share to $.12 per share. Additionally, absent waiver, the restating of the financials put CDC in technical default of some of its bank covenants as of the end of the first and second quarters of 1985. Even with the restated 1984 income, CDC was not in default of those bank covenants as of year end 1984.

Plaintiffs' theory was that the NOL carryforward and the EESI accounting issues were improperly used by CDC. This overstated income for the year 1984 allowed CDC to avoid violating its bank covenants, and in turn inflated the value of its stock. Various witnesses testified as to the company's

improper use of the NOL in this situation, violations of generally accepted accounting principles and generally accepted auditing standards, the difficulties CDC was having, and the risks CDC faced were they to default on their bank covenants. However, it was undisputed that even had CDC accounted for these items as was done in the restatement, the company would not have been in default of its bank covenants as of December 31, 1984. Additionally, no witness testified that CDC would have had to disclose in its 1984 financial statements that it was *close* to violating its bank covenants.

The flaw in plaintiffs' case comes from their inability to connect the alleged impropriety of the defendants to any damages to the shareholders. John B. Torkelson was the plaintiffs' damage expert. He testified that, assuming there was liability on the part of the defendants, the plaintiff class was damaged in the amount of $79 million. He derived this figure by establishing a base line price for CDC stock on August 13, 1985. Accoring to Torkelson, CDC stock was selling at an inflated price up to that date because the shareholders were unaware of the possibility of CDC's impending default on its bank covenants. He testified that the possibility, indeed fact of, default only became known to the public as of August 13. On that date, the *Wall Street Journal* published an article disclosing that the August 6 restatement by CDC put it in technical default of its bank covenants as of March 31 and June 30, 1985. On August 12 and 13, when this information became generally known, the price of CDC stock fell from $26.00 to $23.00 per share in high volume. Torkelson also opined that it was the threat of violating its bank covenants, rather than the fact of default, which was of significance to the shareholder. His opinion was that throughout the class period, the value of CDC stock was inflated solely because the purchasing public was not aware of how seriously close CDC was to violating its bank covenants.

Mr. Torkelson did not say that the improper accounting in the 1984 financial statements was the cause of plaintiffs' damages. Torkelson was specifically asked about the effect

the restating of the 1984 financial statements had on the price of CDC stock. He stated that in and of themselves, the effect on the price of CDC stock because of the NOL and EESI issues was insignificant.

Combining the expert testimony of plaintiffs' witnesses left the court with the following scenario. The accounting experts testified that defendants' actions did not comport with generally accepted accounting principles and generally accepted auditing standards (the NOL and EESI issues), but the plaintiffs' damage expert stated that no damages flowed from those improprieties. The plaintiffs' damage expert did say that damages flowed from the defendants' non-disclosure of possible bank covenant defaults, but the accounting experts did not opine that this non-disclosure was improper. Plaintiffs' experts were therefore akin to two ships which passed in the night. There was evidence of damages, and there was evidence of improper conduct on the part of the defendants. However, the improper conduct did not cause the damage, nor were the damages produced by conduct which was classified as improper.

As a possible last resort for plaintiffs, the court considered narrowing the plaintiffs' class to those people who purchased CDC stock after March 31, 1985. As of that date, using the restated figures, CDC was in technical default under its bank covenants. However, using that date would be basing damages on speculation and possibility. It is possible that had the CDC used its restated figures originally, it would have obtained waivers or renegotiated those covenants prior to default. Also, there was no testimony that the disclosure of violated covenants in April would have caused the price of stock to drop, nor was there testimony that CDC would even have had to disclose those violations. Finally, counsel for plaintiffs, in opposing the directed verdict motions, stated that the class for which they were entitled to damages commenced on January 7, 1985, and not after the end of the first quarter. For whatever reasons, no evidence was introduced which would allow the issue of damages for a narrower class to go to the jury.

Based on the foregoing, the briefs and memoranda of counsel, the testimony adduced at trial, and the entire record as presently constituted,

IT IS HEREBY ORDERED That:

1. Defendants Control Data Corporation, Peat, Marwick, Main & Co., William C. Norris, Norbert R. Berg, Robert M. Price, Jack J. Karnowski, and Marvin G. Rogers's motions for directed verdict are GRANTED; and

2. The Clerk of Court is directed to enter judgment as follows:

   IT IS ORDERED, ADJUDGED AND DECREED That the class action suit arising from the consolidated complaint entitled *In Re: Control Data Securities Litigation*, No. 3-85-1341, is dismissed in its entirety and with prejudice and that the plaintiffs have and recover nothing by their complaint.

DATED: February 8, 1990.

/s/ DONALD D. ALSOP
Donald D. Alsop
Chief U.S. District Judge

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
THIRD DIVISION

3-85 CIV 1341

IN RE: CONTROL DATA CORPORATION
SECURITIES LITIGATION

This matter comes before the court on appeal by defendant Peat, Marwick, Main & Co. ("PMM") from Magistrate Janice M. Symchych's Order Compelling Discovery dated December 10, 1987. PMM is joined by Control Data Corporation ("CDC") and the individually named defendants. Pursuant to 28 U.S.C. § 636(b)(1)(A), an order of the magistrate is not to be overturned unless it is found to be clearly erroneous or contrary to law. *See also*, Local Rule 16(b)(2). This court has reviewed the record before the magistrate, and has reviewed the memoranda of law that have been submitted to it by the parties.

The magistrate's order analyzed the factual and procedural background of this case. She reviewed the basic discovery principles in a concise and thoughtful manner. The magistrate then examined each of the issues as it related to the various discovery requests. Her review and analysis was not only thorough but clear as well. The issues were complex. The magistrate is to be commended for sifting through the myriad of discovery requests and objections and addressing each of the issues before her.

The defendant, PMM, contends that the magistrate committed clear error. First, PMM is concerned that the magistrate's order allows the shareholders an "undeserved license to explore matters not in the least related to their claims." Defendant PMM's Reply Memorandum in Support of Appeal at 3 (Jan. 22, 1988). The defendants' concern is unwarranted. There are three specific accounting related issues asserted by

the plaintiffs in their pleadings. This court recognizes that any granted discovery request must be reasonably calculated to lead to admissible evidence as to these three issues. *Oppenheimer Fund, Inc. v. Sanders*, 437 U.S. 340, 351 (1978); *Hickman v. Taylor*, 329 U.S. 495, 501 (1947); *Dabney v. Montgomery Ward & Co., Inc.*, 761 F.2d 494, 499 (8th Cir. 1985).

Likewise, PMM is concerned that discovery will be opened up for any time period. Defendant PMM's Reply Memorandum in Support of Appeal at 4 (Jan. 22, 1987). The magistrate did find that there cannot be a time frame limit on discoverable facts because it is not unlikely that post offering statements, documents, or other conduct could lead to admissible evidence on the issues of scienter, intent and knowledge. *In Re: CDC Securities Litigation*, No. 3-85-1341, slip op. at 5 (Magistrate's Order Dec. 10, 1987). PMM complains that the plaintiffs' discovery requests will generate thousands of pages of irrelevant information. It is possible, however, that such discovery requests will lead to admissible evidence which is in conformity with the standards of Fed. R. Civ. P. 26(b)(1). The magistrate in her order specifically narrowed some discovery requests concerning "CDC's overall financial health and other specific financial events . . . to the period from the class period up until December 31, 1985." *In Re: CDC Securities Litigation*, No. 3-85-1341, slip op. at 6, 8 (Magistrate's Order Dec. 10, 1987). These conclusions of the magistrate are not clearly erroneous nor contrary to law.

Finally, it is necessary to point out that the defendant PMM's appeal from Doc. Request 33 is withdrawn under the understanding that "*[n]one* of the documents requested in Doc. Request 33 seek a generalized production of PMM's literature, guidelines and manuals." Plaintiffs' Memorandum in Opposition at 14, n. 5 (Jan. 14, 1987) (emphasis in original). *See* Defendant PMM's Reply Memorandum at 8 (Jan. 22, 1988).

It is clear that Magistrate Symchych gave thorough and thoughtful consideration to the positions advanced by all parties. The analysis given by the magistrate is not clearly erroneous, nor is it contrary to law. All parties are reminded that

this grant of discovery shall not expand the issues as presently framed. This litigation has been extended and complex. Counsel are doing little to ease the burden that such litigation imposes on both the court and their clients.

IT IS ORDERED That Magistrate Janice M. Symchych's Order Compelling Discovery dated December 10, 1987 be, and the same hereby is, affirmed.

DATED: February 22, 1988.

/s/ DONALD D. ALSOP
Donald D. Alsop
Chief U.S. District Judge

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
THIRD DIVISION

MASTER FILE NO. 3-85-1341

IN RE: CONTROL DATA CORPORATION
SECURITIES LITIGATION

ORDER

This matter comes before the court on plaintiffs' motion to certify a class action pursuant to Fed. R. Civ. P. 23. The proposed class is:

> All persons or entities who purchased common stock of Control Data Corporation in the open market during the period beginning January 7, 1985 and ending August 6, 1985, excluding defendants, subsidiaries and affiliates of the corporate defendant, members of the immediate families of the individual defendants and the successors or assigns of any of the defendants.

BACKGROUND

This action is brought by investors who purchased Control Data Corporation ("CDC") securities to enforce rights created by the anti-fraud provisions of the Securities Exchange Act of 1934, 15 U.S.C. § 78(a) *et seq.*, particularly Section 10(b) thereof, Rule 10b-5 promulgated thereunder, and principles of common law. The defendants in this action are CDC and Peat, Marwick, Mitchell & Co. ("PMM"), CDC's independent auditor. Plaintiffs' consolidated complaint alleges claims based upon Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, common law fraud, and negligent misrepresentation.

The plaintiffs allege, in essence, that from January 7, 1985 through August 6, 1985, defendants issued false and misleading documents and statements concerning CDC's operations and financial condition, including a CDC 1984 Annual Report, a Form 10K, an interim report, optimistic statements concerning CDC's business operation and financial condition, and the employment of deceptive and manipulative accounting practices. The plaintiffs further allege that these false and misleading representations were intended to and did convey to the investing public a false and misleading impression of a profitable, financially sound, and growing company. The actions of the defendant are alleged to have resulted in an artificially inflated and maintained market price for CDC common stock through the class period.

DISCUSSION

A. INTRODUCTION

In order to proceed as a class action, plaintiffs must first meet the four requirements of Fed. R. Civ. P. 23(a), which provides that:

> (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

Plaintiffs must then prove that their action falls within one of three categories listed in Rule 23(b). Plaintiff seeks to certify under Rule 23(b)(3), which provides that an action may proceed as a class action if:

> (3) the court finds that questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair

> and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of the members of the class in individually controlling the prosecution and defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.

The district court is given broad discretion to determine the maintainability and the conduct of class actions. *See, e.g., Vervaecke v. Chiles, Heider & Co., Inc.*, 578 F.2d 713, 719 (8th Cir. 1978); *Emery Cessna Aircraft Distributorship Antitrust Litigation*, 518 F.2d 213, 215 (8th Cir.) *cert. denied*, 423 U.S. 947 (1975). When exercising this discretion, this court is mindful that the class action device is a necessary vehicle for the vindication of small claims, especially when the nature of the claim involves complex litigation. *See, e.g., Vernon J. Rockler & Co. v. Graphic Enterprises, Inc.*, 52 F.R.D. 335, 347 (D.Minn. 1971); *Weiss v. Tenney Corp.*, 47 F.R.D. 283, 291 (S.D.N.Y. 1969). Commenting on the importance of the class action device in the area of securities litigation, the Third Circuit has stated that "the interest of justice requires that in a doubtful case . . . any error, if there is to be one, should be committed in favor of allowing the class action." *Kahan v. Rosenstiel*, 424 F.2d 161, 169 (3d Cir.) *cert. denied*, 398 U.S. 950 (1970) (quoting *Esplin v. Hirschi*, 402 F.2d 94, 101 (10th Cir. 1968)).

Because Fed. R. Civ. P. 23(3)(c)(4) authorizes a court to certify a class as to one or more claims without certifying the entire complaint, the court will address each of the requirements for class certification as they apply to the federal claims and the state law claims.

B. FEDERAL CLAIMS

1. *Rule 23(a)(1)—Numerousity*

The numerousity provision of Rule 23(a)(1) requires that a class be so numerous that joinder of all of its members is impracticable. In the present case, the proposed class is sufficiently numerous to render joinder of all claims impracticable. Indeed, defendants agree that the numerousity requirement of Fed. R. Civ. P. 23(a) is satisfied. There were approximately 38,502,533 shares of CDC common stock outstanding as of June 30, 1985. During the class period, more than 40,000,000 shares of CDC common stock were traded. While the plaintiffs have not established the exact number of class members, they have demonstrated that the class will be sufficiently numerous to satisfy the requirement of Rule 23(a). *See In re Victor Technologies Securities Litigation*, 102 F.R.D. 53, 56 (N.D. Cal. 1984).

2. *Requirement of Rule 23(a)(2)—Commonality*

The commonality provision of Rule 23(a)(2) requires that the claims the class members share substantial and common questions of law or fact. *See, e.g., Jenson v. Continental Financial Corp.*, 404 F. Supp. 806, 809 (D. Minn. 1975). To succeed in a private action pursuant to Rule 10b-5,[1] a plaintiff must establish:

> (1) that defendant acted in a manner prohibited by the Rule, whether it be that the defendant employed a device, scheme, or artifice to defraud, made misrepresentations or omissions of material facts, or engaged in acts, practices, or courses of business that operated as fraud or deceit;
>
> (2) causation, often analyzed in terms of materiality and reliance;

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1 Rule 10b-5 was promulgated pursuant to Section 10(b) of the Securities Exchange Act of 1934.

(3) scienter, that is an intent to deceive, manipulate, or defraud;

(4) damages; and

(5) the fraudulent activity occurred in connection with the purchase of sales securities.

Harris v. Union Electric Co., 787 F.2d 355, 362 (8th Cir. 1986) (citations omitted). *See also Austin v. Loftsgaarden*, 675 F.2d 168, 176-80 (8th Cir. 1982).

In the present case, the gravamen of the plaintiffs' complaint concerns alleged misstatements of income contained in a 1984 Annual Report, Form 10-K, and an interim report for the first half of 1985. Because these documents were uniform and broadly distributed, there are numerous common issues of law and fact relative to the plaintiffs' Rule 10b-5 claim. Examples of common issues that will likely exist are:

(1) Whether the defendants misstated their income during the relevant time period.

(2) Whether the misstatements were material.

(3) Whether the defendants had the intent to deceive, manipulate, or defraud the plaintiffs through the misstatements.

(4) Whether the theory of fraud on the market should apply in this case.

Indeed, defendants concede that a number of common questions of law and fact exist.[2] Accordingly, the court concludes that the plaintiffs' federal claims present common questions of law and fact.

3. *Requirement of Rule 23(a)(3)—Typicality*

Generally, the typicality requirement is tested in terms of lack of antagonism among the claims or defenses of the rep-

2 Although conceding that common questions of law and fact may exist, the defendants suggest that these common questions do not predominate and are far outnumbered by individual questions of law and fact.

resentatives and those of the class members. J. Friedenthal, M. Kane, A. Miller, *Civil Procedure* at 729 (1980); *see also Hurwitz v. R. B. Jones Corp.*, 76 F.R.D. 149, 158 (W.D. Mo. 1979); *Metge v. Baehler*, 77 F.R.D. 470, 475 (S.D. Ia. 1978); *Graphic Enterprises*, 52 F.R.D. at 340. The claims or potential defenses need not be identical, and typicality usually will be satisfied if the claims or defenses of the representatives and the class stem from the same events or rest on the same legal theories. *See, e.g., In re Data Access Systems Securities Litigation*, 103 F.R.D. 130, 139 (D. N.J. 1984); *Jones v. Blinziner*, 536 F. Supp. 1181 (N.D. Ind. 1982); *Holland v. Steele*, 92 F.R.D. 58 (N.D. Ga. 1981). When the claims or defenses of the representatives and the class are based on the same course of conduct or legal theory, it is thought that the representatives will advance the interest of the class members by advancing his or her own interests. *See Zeffiro v. First Pennsylvania Banking & Trust Co.*, 96 F.R.D. 567 (E.D. Pa. 1983); *Leist v. Tamco Enterprises, Inc.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,633 (S.D. N.Y. Mar. 16, 1982). *See generally* 4 Newberg, *Class Actions*, § 22.11 at 29 (1977). The advancement of the common interests of class members, however, may be jeopardized when the defendant can assert defenses against the representatives that are not applicable to the majority of the class members. The existence of defenses unique to the class representatives raises concerns that the representatives' attention and the focus of the litigation will be shifted from issues common to the class to defenses unique to the representatives. *See, e.g., Koos v. First National Bank of Peoria*, 496 F.2d 1162 (7th Cir. 1974); *Masri v. Wakefield*, 106 F.R.D. 322 (D. Col. 1984); *Cohen v. Laiti*, 98 F.R.D. 581, 583-84 (E.D.N.Y. 1983). Although the district court should not consider the merits of the plaintiffs case in deciding the certification issue, *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 178 (1974), when the requirements of commonality and typicality are brought into question, it may be necessary that the court analyze the substantive claims and defenses of the parties. *Hurwitz*, 76 F.R.D. at 157.

In the present case, the defendants argue that the named plaintiffs' lack of reliance subjects the plaintiffs to unique defenses. Examples of conduct cited by the defendants in support of their claim of unique defenses are speculation (plaintiff Page), sophistication (plaintiff Steiner), and lack of sophistication (plaintiff Randall). Consequently, the defendants argue, plaintiffs' federal claims are not typical of the class and certification must be denied.

The court rejects the defendants' argument that variations in reliance raise unique defenses and preclude a showing of typicality. If reliance is an element of the plaintiffs' 10b-5 claim, it is one that applies to each class member. As stated by the court in *Graphic Enterprises* "[r]eliance is an issue lurking behind every securities fraud claim, and to require that it first be proven, would effectively negate the concept of a 10b-5 class action." *Graphic Enterprises*, 52 F.R.D. at 345. Acceptance of the defendants' argument would effectively prevent certification of all non-omission 10b-5 claims. There is nothing unique about a defense of lack of reliance. *See Hurwitz*, 76 F.R.D. at 158. *In re Data Access*, 103 F.R.D. at 136.

The court is sufficiently persuaded that the focus of the representatives' attention and the litigation will be on issues common to the class and not on the issue of reliance. Accordingly, the court concludes that plaintiffs' federal claims are typical of the federal claims of the class.

4. *Requirement of Rule 23(a)(4)—Adequate Representation*

The adequate representation provision of Fed. R. Civ. P. 23(a)(4) requires that the interests of the named plaintiffs and the other members of the class coincide and it appears that the plaintiffs and their attorneys will vigorously prosecute the action. *See, e.g., In re Data Access Systems*, 103 F.R.D. at 140; *Piel v. National Semi Conducter Corp.*, 86 F.R.D. 367, 365 (E.D. Pa. 1980). The defendants do not argue that the named plaintiffs and their attorneys will not vigorously prosecute this action. The defendants argue that because they can assert defenses against the plaintiffs based upon lack of reli-

ance, the interests of the named plaintiffs and the class members do not coincide. Much of the above discussion regarding the affect of the reliance defense on typicality is equally applicable to this aspect of the adequate representation requirement. Indeed, many courts and scholars finds the two requirements redundant when evaluating unique defenses.[3] *See Masri*, 106 F.R.D. at 325; *Hurwitz*, 76 F.R.D. at 156; *accord Kline*, 88 F.R.D. at 699; *Civil Procedure*, *supra*. at 729. The court feels it is unnecessary to reiterate its analysis of the defendants' argument that their defense of lack of reliance creates antagonism between the named plaintiffs and the class. The court is confident that the named plaintiffs' interests sufficiently coincide with the interests of class members and the plaintiffs will adequately represent those class members despite an allegation of lack of reliance.

5. *Requirement of Rule 23(b)(3)—Common Questions of Law or Fact Predominate*

The provision of 23(b)(3) requires that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fair and efficient adjudication of the controversy. The defendant argues that questions of law or fact common to the class do not predominate over questions affecting individual class members because of differences in reliance on the alleged misrepresentations. In support of this proposition the defendant cites to *Raymond v. Miller & Schroeder Municipals, Inc.*, [1983-84 Transfer Binder] Fed. Sec. L. Rep. ¶ 99,714 (D. Minn. 1983), a case authored by this court. The defendants' reliance on *Raymond* is misplaced. In *Raymond* the alleged written misrepresentations were stated in different ways in several different documents. Moreover, varying oral representations were made to individual plaintiffs by separate salespersons. In other words, the alleged misrepresentations

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3 In their brief, the defendants acknowledge that with regard to unique defenses the requirement of 23(a) (3) and the requirement of 23(a) (4) are closely related.

were local in scope and targeted towards the specific plaintiffs to whom they were made. In contrast, the present case involves alleged misrepresentations[4] that are not inconsistent, of a national scope, and targeted towards the marketplace of buyers and sellers of broadly traded securities.

Assuming that reliance is a necessary element of the plaintiffs' 10b-5 claim, common questions such as whether any misrepresentations were made, whether the misrepresentations were material, whether the defendants intended to deceive or defraud the plaintiffs through the misrepresentations, whether reliance is a required element of the plaintiffs' federal claims, clearly predominate over the individual issue of reliance. Moreover, a class action is superior to other available methods for fair and efficient adjudication of this dispute. Accordingly, the court concludes that the plaintiffs have satisfied the requirement of 23(b)(3).

C. STATE LAW CLAIMS

In addition to their federal claims the plaintiffs assert two state law claims based upon common law fraud and negligent misrepresentation. The Rule 23(a) analysis, (numerousity, commonality, typicality, and adequate representation) of the plaintiffs' common law claims is substantially similar to the court's analysis of the plaintiffs' federal claims. Without discussing each of the individual requirements of 23(a), the court is satisfied that the plaintiffs' common law claims comply with those requirements. Satisfaction of the requirement of 23(b)(3), however, is a much closer question. For reasons discussed below, this court believes that sound discretion counsels against certification of the state law claims.

The plaintiffs argue that the court can apply Minnesota common law principles to the common law claims of all the class members, including the class members who reside outside the state of Minnesota. This approach, according to the plaintiffs, eliminates the need for a choice of law analysis,

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4 The alleged misrepresentations include statements made in documents issued by CDC, as well as statements made to the public through press reports and other public announcements.

enhancing the manageability of the common law claims. In contrast, the defendants argue that a *Milkovich* choice of law analysis is required, and that variations in state law render the common law claims unmanageable.

The court recognizes that it may well be able to constitutionally apply Minnesota law to all of the individual claims of the class. *Phillips Petroleum Co. v. Shutts*, ____ U.S. ____, 105 S.Ct. 2965 (1985). In *Shutts* the Supreme Court formulated a two step analysis for determining whether a forum state may constitutionally apply its law to all of the individual claims of the class. The first issue that must be resolved is whether the forum state's law "conflicts in any material way with any other law which could apply." *Id.* at 2977. In the present case, it is likely that material conflicts exist between the potentially applicable state law regarding both common law fraud and negligent misrepresentation. *See* cases cited *infra* footnote 6. If a conflict exists, the court must then determine whether the forum has "a significant contact or aggregation of contacts to the claims asserted by each member of the plaintiff class, contacts creating state interests in order to ensure that the choice of [forum] law is not arbitrary or unfair." *Id.* at 2980. (quoting in part *Allstate Ins. Co. v. Hague*, 449 U.S. 302, 312-13 (1981)).

In the present case, the undisputed contacts attributable to Minnesota include the following:

1. CDC is a Minnesota corporation.

2. CDC's principal place of business is Minnesota.

3. Most of the press releases and other public statements emanated from Minnesota.

4. The defendants transact business in Minnesota.

Accordingly, the court is satisfied that the state of Minnesota has sufficient contacts to ensure that the choice of Minnesota law would not be arbitrary or unfair.[5] *See In re Computer*

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5 The federal courts are split concerning the ease with which plaintiffs can join state common law fraud claims with federal claims through pen-

Memories Securities Litigation, No. C-85-2335 EFL, slip op. at 21 (N.D. Cal. Aug. 26, 1986).

Notwithstanding the constitutional ability to apply Minnesota law, the court believes that the class members have a significant interest in individually controlling the prosecution of these tort claims in the forum of their choice because of the significant variations in state law with regard to the alleged common law torts,[6] especially negligent misrepresentation.[7] Out of concern of manageability, the court does not consider performing a *Milkovich* choice of law analysis as a viable alternative to either applying Minnesota law to all claims of the class or allowing the class members to individually control the prosecution of their state claims. Accordingly, the court will deny the plaintiffs' motion to certify their common law fraud and negligent misrepresentation claims pursuant to 23(c)(4).

Based upon the record before the court and the foregoing discussion,

IT IS ORDERED That as to their federal claims, the plaintiffs' motion to certify a class be and the same hereby is granted and the following class is certified:

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dency. *Compare Dekro v. Stan Brothust Co.*, 540 F.2d at 418 (W.D. Mo. 1982) and *In re Victor Tech. Securities Litigation*, 102 F.R.D. at 59 with *Piel*, 86 F.R.D. at 367 and *Raymond*, Fed. Sec. L. Rep. (CCH) at ¶ 99,714.

6 *See Sanders v. Robinson Humphrey/American Express, Inc.*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,548, at 93,284 (N.D. Ga. 1986) (discussing variations in knowledge, intent and justifiable reliance standards regarding common law fraud). *Compare H. Rosenblum, Inc. v. Adler*, 461 A.2d 138, 153 (N.J. 1983) (negligent misrepresentation can be maintained by any person defendants should reasonably have foreseen would rely on defendants' misrepresentation) *with Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 439 N.Y.S. 435, 483 N.E.2d 110, 115 (1985) (third-parties not in a relationship to defendants so close as to approach that of privity cannot assert claims of negligent misrepresentation).

7 The Minnesota Supreme Court has recently held that the State's comparative fault statute applies in cases of negligent misrepresentation. *Florenzano v. Olson*, 387 N.W.2d 168, 175-76 (Minn. 1986).

To the extent that they have claims under federal law, all persons or entities who purchased common stock of Control Data Corporation in the open market during the period beginning January 7, 1985 and ending August 6, 1985, excluding defendants, subsidiaries and affiliates of the corporate defendant, members of the immediate families of the individual defendants and the successors or assigns of any of the defendants.

IT IS FURTHER ORDERED That as to their state common law claims, the plaintiffs motion to certify a class be and the same hereby is denied.

DATED: December 1, 1986.

/s/ DONALD D. ALSOP
Donald D. Alsop
Chief U.S. District Judge

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
THIRD DIVISION

MASTER FILE NO. 3-85-1341

IN RE: CONTROL DATA CORPORATION
SECURITIES LITIGATION

ORDER

This matter comes before the court on defendant Control Data Corporation's (CDC) appeal pursuant to Local Rule 16 and Fed. R. Civ. P. 72(a) of the magistrate's order dated June 2, 1986. In that order, Magistrate Janice M. Symchych denied defendant's motion to compel responses to certain interrogatories and document requests, granted in part and denied in part defendant's motion to compel depositions in the forum, and denied defendant's motion for extension of the certification-related discovery deadline.

FACTS

Plaintiffs are investors who purchased CDC securities during the time period beginning January 7, 1985 and ending August 6, 1985. Plaintiffs' consolidated complaint alleges claims based upon Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, common law fraud, and negligent representation. Plaintiffs assert that CDC unlawfully misstated its income for fiscal year 1984 and the first two quarters of 1985 in registration documents filed with the SEC in connection with a public offering of its stock. The parties have agreed to bifurcate class certification

related and merits discovery, which was formalized in Pretrial Order No. 2.

DISCUSSION

I. MOTION TO COMPEL DISCOVERY

A dispute has arisen concerning the proper scope of class certification related discovery (certification-related discovery). Without reiterating the specific interrogatories and document requests that are the subject of this dispute, the defendant's discovery requests fall into three general categories. The first category involves inquiries pertaining to the individual plaintiffs' security transactions. The second category involves an inquiry regarding the individual plaintiffs' litigation history. The final category involves attempted discovery of evidence relating to the financial well-being of the individual plaintiffs. Defendant's motion to compel discovery was heard before Magistrate Janice M. Symchych on April 18, 1986 and denied in its entirety in an order dated June 2, 1986.

At the outset, it should be emphasized that the issue before the court is the proper scope of certification-related discovery and *not* whether the proposed class should be certified. Accordingly, the appropriate starting point is Rule 26(b)(1) of the Federal Rules of Civil Procedure, which provides that the scope of discovery is as follows:

> In general—Parties may obtain discovery regarding *any matter*, not privileged, which is *relevant to the subject matter involved in the pending action*, whether it relates to the claim or defense of the party seeking discovery or to the claim or defense of any other party, including the existence, description, nature, custody, condition and location of any books, documents or other tangible things and identity and location of the persons having knowledge of any discoverable matter. (Emphasis added.)

Rule 33 provides that interrogatories may relate to any matter which can be inquired into under Rule 26(b). Similarly, Rule 34 provides that any party may serve on the other party a request to produce documents within the scope of Rule 26(b). If a party fails to provide the answers to interrogatories or produce the documents requested, the discovering party is authorized to move for an order compelling discovery. Fed. R. Civ. P. 37(a)(2).

It is well settled that discovery may be utilized to ascertain evidence relating to the presence or absence of class requirements. *See, e.g., Oppenheimer Fund, Inc. v. Sanders*, 437 U.S. 340, 347 n.13 (1978); *Kamm v. California City Dev. Co.*, 509 F.2d 205, 209-10 (9th Cir. 1975); *In re Dist. of California "Dalkon Shield IUD Products"*, 526 F. Supp. 887, 917 (N.D. Cal. 1981). *See generally* Annot., *Discovery for Purposes of Determining Whether Class Action Requirements Under Rule 23(a) and (b) of the Federal Rules of Civil Procedure Are Satisfied*, 24 A.L.R. Fed. 827 (1975). However, the decision of whether to allow certification-related discovery, and if so, to what extent, lies within the sound discretion of the trial court. *See Kamm*, 509 F.2d at 209; *In re Dist. of California "Dalkon Shield IUD Products"*, 526 F. Supp. at 917; *Berlard v. Mack*, 48 F.R.D. 121, 126 (S.D.N.Y. 1969). In determining whether to allow certification-related discovery, the court might consider "its need, the time required, the probability of discovery, resolving any factual issue necessary for the class determination." *Kamm*, 509 F.2d at 210.

Therefore, in reviewing the magistrate's order, the court must consider whether the evidence requested meets the threshhold requirement of relevancy, and if so, does sound discretion counsel for or against discovery. It should be noted that the plaintiffs have the burden of proving that the discovery requested is not relevant to the issues before the court. *See, e.g., Zucker v. Sable*, 72 F.R.D. 1, 3 (S.D.N.Y. 1975).

Interrogatory Request Nos. 8, 9, 10, 11, 12, 13, 14 and 15
Request For Production Of Documents Nos. 3, 4, 5, 6 and 7

Without reiterating each of these individual interrogatories 15 and document requests, they are directed at discovering evidence pertaining to the individual plaintiffs' security transactions, including transactions unrelated to CDC securities. The defendant asserts that this information is useful in evaluating reliance as it relates to the typicality requirement of Rule 23(a)(3) and the adequacy of representation requirement of Rule 23(a)(4). The plaintiffs argue and the magistrate concluded that "reliance fails to bear" on the issues of typicality and adequate representation. *In re Control Data Securities Litigation*, No. 3-85-1341, slip op. at 3-4 (D. Minn. June 2, 1986).

The role that reliance plays at the certification stage has been subject to varied interpretation by the courts. *Compare In re Data Access Systems Securities Litigation*, 103 F.R.D. 130, 139-40 (D. N.J. 1984) (issue of reliance goes to the merits of the case and does not render plaintiff's claim atypical) and *Hurwitz v. R. B. Jones Corp.*, 76 F.R.D. 149, 158 (W.D. Mo. 1979) (same) *with Cohen v. Laiti*, 98 F.R.D. 581, 583 (E.D.N.Y. 1983) (evidence indicating plaintiff did not rely on the integrity of the market precluded certification) and *Lewis v. Johnson*, 92 F.R.D. 758, 759-60 (E.D.N.Y. 1981) (same) and *Kline v. Wolf*, 88 F.R.D. 696, 699 (S.D.N.Y. 1981) (same). Generally, the typicality requirement is tested in terms of lack of antagonism among the claims and defenses of the representatives and those of the class members. J. Friedenthal, M. Kane, A. Miller, *Civil Procedure* at 729 (1980) [hereinafter Civil Procedure]; *see also Hurwitz*, 76 F.R.D. at 158; *Metge v. Baehler*, 77 F.R.D. 470, 475 (S.D. Ia. 1978); *Vernon J. Rockler and Co., Inc. v. Graphic Enterprises, Inc.*, 52 F.R.D. 335, 340 (D. Minn. 1971). The claim or potential defenses need not be identical, and typicality usually will be satisfied if the claims and defenses of the representative and the class stem from the same events or rest on the same legal theories. *See, e.g., In re Data Access Systems Securities Litigation*, 103 F.R.D. at 139;

Jones v. Blinziner, 536 F. Supp. 1181 (N.D. Ind. 1982); *Holland v. Steele*, 92 F.R.D. 58 (N.D. Ga. 1981). When the claims and defenses of the representative and the class are based on the same course of conduct or legal theory, it is thought that the representative will advance the interests of the class members by advancing his or her own interest. *See Zeffiro v. First Pa. Banking and Trust Co.*, 96 F.R.D. 567 (E.D. Pa. 1983); *Leist v. Tamco Enterprises, Inc.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,633 (S.D.N.Y Mar. 16, 1982). *See generally* 4 Newberg, *Class Actions*, § 22.11 at 29 (1977). The advancement of the common interest of the class members, however, may be jeopardized when the defendant can assert defenses against the representatives that are not applicable to the majority of the class members. The existence of defenses unique to the class representatives raises concern that the representatives' attention and the focus of the litigation will be shifted from issues common to the class to defenses unique to the representatives. *See, e.g., Koos v. First National Bank of Peoria*, 496 F.2d 1162 (7th Cir. 1974); *Masri v. Wakefield*, 106 F.R.D. 322 (D. Col. 1984); *Cohen*, 98 F.R.D. at 583-84.

With regard to the adequate representation requirement, courts have consistently applied a two-prong test. Specifically, courts have considered whether the named plaintiffs have interests antagonistic to those of the class and whether the plaintiffs' attorney is qualified to conduct the proposed litigation. *In re Data Access Systems Securities Litigations*, 103 F.R.D. at 140; *see also Piel v. Nat. Semiconductor Corp.*, 86 F.R.D. 367, 365 (E.D. Pa. 1980). With regard to the first prong of the test, much of the above analysis is equally applicable to the requirement of adequate representative. Indeed, many courts and scholars find the two requirements redundant when evaluating unique defenses. *Hurwitz*, 76 F.R.D. at 156; *Masri*, 106 F.R.D. at 325; *accord Kline*, 88 F.R.D. at 699, *Civil Procedure*, *supra*, at 729. Accordingly, the presence of an arguable defense peculiar to the class representative may destroy typicality as well as bring into question the adequacy of the named plaintiffs' representation.

See, e.g., J. H. Cohn & Am. Apprisal Assoc., Inc., 628 F.2d 994, 999 (7th Cir. 1980).

At this stage in the proceedings, this court is not willing to decide the precise role that investor reliance will play when deciding the plaintiffs' motion for certification. For purposes of deciding the scope of discovery, however, the court concludes that reliance is a relevant consideration, to the extent that individual investor reliance raises unique defense(s) not applicable to the majority of class members. In the present case, the defendant might use evidence pertaining to the individual plaintiffs' investment activities to prove two distinct unique defenses.

First, with regard to the plaintiffs' assertion that they relied on the integrity of the market, the requested information might reveal the use of unusual investment strategies raising questions concerning the plaintiffs' reliance on the market's integrity. *See Masri*, 106 F.R.D. at 324-25; *Cohen*, 98 F.R.D. at 582-84; *Lewis*, 92 F.R.D. at 760; *Kline*, 88 F.R.D. at 699. The presumption of reliance that flows from an allegation of fraud on the market might be rebutted by proving that all or some of the named plaintiffs utilized investment strategies that did not rely on the market to evaluate information. *See Cohen*, 98 F.R.D. at 583; *Lewis*, 92 F.R.D. at 759. *See generally* Note, *The Fraud-On-The-Market Theory*, 95 Harv. L. Rev. 1142 (1982). Although not dispositive, the existence of a unique defense based upon an unusual investment strategy certainly satisfies the relevancy requirement of Fed. R. Civ. P. 26(b)(1). *See Masri*, 106 F.R.D. at 324-25; *Cohen*, 98 F.R.D. at 581-83; *Lewis*, 92 F.R.D. at 760; *Kline*, 88 F.R.D. at 698-99. *Cf. Hurwitz*, 76 F.R.D. at 158.

Second, with regard to the plaintiffs' claim based on common law fraud, the requested information might reveal the absence of actual reliance on the defendant's financial statements. Common law fraud requires the individual investor to prove both actual reliance and that the investor was justified in relying on the relying on the representations made. *Raymond v. Miller & Schroeder Municipals, Inc.*, [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,714 (D.

Minn. Mar. 28, 1984); *Tober v. Charnita, Inc.*, 58 F.R.D. 74, 84-85 (N.D. Pa. 1973); *Davis v. Re-Trac Mfq. Corp.*, 149 N.W.2d 37, 39 (1967). Because Fed. R. Civ. P. 23(3)(4) authorizes a court to certify a class as to one or more claims without certifying the entire complaint, the degree of variation in reliance by individual investors is a relevant, though not dispositive consideration when deciding a motion to certify a class.[1] *Piel*, 86 F.R.D. at 367; *Raymond*, Fed. Sec. L. Rep. (CCH) at ¶ 99,714. *But see In re Victor Tech. Securities Litigation*, 102 F.R.D. 53, 59 (N.D. Cal. 1984).

Accordingly, the defendant's discovery request relating to the individual plaintiffs' investment activities meets the threshhold requirement of relevancy. Moreover, the court feels that evidence of unique defenses, if it exists, should be before the court when it decides the plaintiffs' motion for certification. Recognizing the significant burden that these particular discovery requests may impose upon the plaintiffs, the time period referred to in Interrogatory Nos. 8, 9 and 10 and Document Request Nos. 3 and 4 is restricted to January 1, 1979 through December 6, 1985.

INTERROGATORY NO. 7

The second category of information requested by the defendant concerns the individual plaintiffs' litigation history. Interrogatory No. 7 asks the individual plaintiffs to identify every lawsuit to which they have been a party. In response, the plaintiffs have offered to identify every class

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1 The federal courts are split concerning the ease with which plaintiffs can join state common law fraud claims with federal claims through pendency. *Compare Dekro v. Stan Brothust Co.*, 540 F.2d at 418 (W.D. Mo. 1982) and *In re Victor Tech. Securities Litigation*, 102 F.R.D. at 59 with *Piel*, 86 F.R.D. at 367 and *Raymond*, Fed. Sec. L. Rep. (CCH) at ¶ 99,714. Again, at this juncture, the court feels it is unnecessary and inappropriate to determine the precise role reliance will play when deciding the plaintiffs' certification motion. For purposes of this discovery appeal, however, the court concludes that reliance is a relevant consideration, to the extent that individual invester reliance raises unique defense(s) not applicable to the majority of class members.

action lawsuit to which the individual plaintiffs were class representatives. This court concludes that prior lawsuits to which the individual plaintiffs were parties are relevant and discoverable to the extent that the subject matter of the lawsuit involved violations of federal or state securities laws. Although mere participation in prior securities litigation is not a relevant consideration when deciding the plaintiffs' motion for certification, *Kames v. Horizon Corp.*, 81 F.R.D. 444 (S.D.N.Y. 1979), such information is reasonably calculated to lead to the discovery of other evidence that is relevant to the issue of certification, such as evidence pertaining to actual reliance or unusual investment strategies. *Cf. Civil Procedure*, *supra*, at 381; 8 C. Wright & A. Miller, *Federal Practice and Procedure*, §§ 2007-15 (1970). Accordingly, plaintiffs must identify all lawsuits to which they were a party, if the lawsuit involved violations of federal or state securities laws, whether or not the lawsuit was in the form of a class action.

DOCUMENT REQUEST NO. 2

This court concurs with the magistrate's order regarding the discoverability of the individual plaintiff's financial statements. While most class action defendants use information regarding the financial well-being of the plaintiffs to question their ability to finance the class litigation, CDC requests this information to show plaintiffs' "financial sophistication and business acumen", but failed to offer any authority suggesting that such information is relevant to the issue of class certification. Evidence of financial sophistication and business acumen is simply not relevant to the issue of certification, nor is it reasonably calculated to lead to other information relevant to the certification issue.

II. MOTION FOR DEPOSITION IN FORUM

A dispute has arisen concerning the appropriate location for depositions of six named plaintiffs for certification-related discovery. Defendant contends that the plaintiffs

should be deposed in the forum district, while the plaintiffs argue that the depositions should be taken at the place where the individual plaintiffs reside. The magistrate concluded that the general rule of deposing plaintiffs in the forum district should apply to all but two of the plaintiffs. *Clem v. Allied Vans Int'l Corp.*, 102 F.R.D. 938 (S.D.N.Y. 1984). As to these two plaintiffs, the magistrate ordered that the depositions should take place where they reside because of personal illnesses and adverse circumstances. It cannot be said that the magistrate's determination is clearly erroneous or contrary to law. Local Rule 16(B).

III. AMENDMENT OF THE SCHEDULE ESTABLISHED BY PRETRIAL ORDER NO. 2

The discovery schedule contained in Pretrial Order No. 2 is amended to allow discovery that is consistent with this order.

Based upon the record before the court and the foregoing discussion:

IT IS ORDERED That the magistrate's order as it relates to the defendant's motion to compel further responses to certification-related interrogatories and document requests is affirmed in part and reversed in part. Accordingly, the plaintiffs should respond to defendant's discovery requests in a manner that is consistent with this order.

IT IS FURTHER ORDERED That the magistrate's order as it relates to the defendant's motion to compel the plaintiffs' depositions to be taken in the District of Minnesota is affirmed.

IT IS FINALLY ORDERED That the magistrate's order as it relates to the defendant's motion for an extension of class-related discovery is reversed, to the extent that the discovery allowed by this order shall be completed forthwith.

DATED: September 12, 1986.

/s/ DONALD D. ALSOP
Donald D. Alsop
United States District Judge

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 90-5107MN

In Re: Control Data Corporation Securities Litigation

DIANE ABBEY, DAVID WEISGAL, WILLIAM STEINER, WILLIAM RANDALL, and JOHN PAGE,

Appellants,

—vs.—

CONTROL DATA CORPORATION, NORBERT R. BERG, WILLIAM C. NORRIS, ROBERT M. PRICE, MARVIN G. ROGERS, and PEAT, MARWICK, MAIN & CO.,

Appellees.

Appeal from the United States District Court
for the District of Minnesota

Appellees' petition for rehearing with suggestion for rehearing en banc has been considered by the court and is denied by reason of the lack of a majority of the active judges voting to rehear the case en banc. Judge Magill recused.

Rehearing by the panel is also denied.

June 26, 1991

Order Entered at the Direction of the Court:
/s/ MICHAEL E. GENS
Clerk, U.S. Court of Appeals, Eighth Circuit

(2)

No. 91-488

FILED
OCT 24 1991
OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

October Term, 1991

KPMG PEAT MARWICK, CONTROL DATA CORPORATION, NORBERT R. BERG, WILLIAM C. NORRIS, ROBERT M. PRICE, and MARVIN G. ROGERS,
Petitioners,

v.

DIANE ABBEY, DAVID WEISGAL, WILLIAM STEINER, WILLIAM RANDALL, and JOHN PAGE,
Respondents.

BRIEF OF RESPONDENTS IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Leonard Barrack
(Counsel of Record)
Sheldon L. Albert
Robert A. Hoffman
BARRACK, RODOS & BACINE
Suite 2100
1845 Walnut Street
Philadelphia, PA 19103
(215) 963-0600

Jack L. Chestnut
Karl L. Cambronne
CHESTNUT & BROOKS, P.A.
3700 Piper Jaffray Tower
222 South Ninth Street
Minneapolis, MN 55402
(612) 339-7300
Attorneys for Respondents

PACKARD PRESS LEGAL DIVISION, 1617 JFK BOULEVARD, PHILA., PA 19103 (215) 563-9000

QUESTIONS PRESENTED

1. In an action brought under Section 10(b) of the Securities Exchange Act of 1934, was it improper for the Court of Appeals to hold that a jury should be allowed to consider all of the available evidence in determining whether plaintiffs have proven loss causation?

2. In an action brought under Section 10(b), should this Court decide abstract issues relating to rebutting the presumption of reliance on the integrity of the market where the issue was not considered by either the district court or Court of Appeals and where the jury has not yet considered the issue?

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No. 91-488

IN THE

Supreme Court of the United States

October Term, 1991

KPMG PEAT MARWICK, CONTROL DATA CORPORATION, NORBERT R. BERG, WILLIAM C. NORRIS, ROBERT M. PRICE, and MARVIN G. ROGERS,
Petitioners,

v.

DIANE ABBEY, DAVID WEISGAL, WILLIAM STEINER, WILLIAM RANDALL, and JOHN PAGE,
Respondents.

BRIEF OF RESPONDENTS IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

STATEMENT OF THE CASE

This case, a consolidated securities class action suit, presents nothing more than the routine factual question of whether plaintiffs adduced sufficient evidence at trial to allow their claims to be heard by a jury. The United States Court of Appeals for the Eighth Circuit ruled that they had. It did not find that plaintiffs had proven their case or any element of it. It did not find that defendants had violated the federal securities laws. In fact, it did not issue any ruling of law whatsoever. All that the Eighth Circuit found was that a jury should be permitted to consider plaintiffs' claims.

Plaintiffs, Diane Abbey, David Weisgal, William Steiner, William Randall and John Page, respondents here, are the certified representatives of a class of shareholders who purchased the common stock of Control Data Corporation ("CDC") during the period January 7, 1985 through and including August 6, 1985 (the "Class Period"). Plaintiffs sued CDC, certain of its directors and/or officers and its outside auditors, KPMG Peat Marwick ("Peat Marwick"), charging that defendants disseminated a series of materially false and misleading statements to the investing public during the Class Period in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder.

After four years of intensive discovery, trial of this action commenced on January 16, 1990. Plaintiffs presented their case in three weeks, at the conclusion of which all defendants moved for a directed verdict. Although defendants' directed verdict motions were based on a variety of grounds, the district court expressly held that except for the element of causation, "the evidence was sufficient to allow the case to go to the jury" on "all other elements" of a Section 10(b) claim. (Petitioners' Appendix at 14a). The district court ruled, however, that it would not permit the case to be considered by the jury because it believed that the evidence showed that "the improper conduct did not cause the damages, nor were the damages produced by conduct which was classified as improper." (Petitioners' Appendix at 16a).

The judgment of the district court granting a directed verdict was reversed by the Court of Appeals. After careful consideration of the trial record, including a twelve volume set of trial transcripts and an Appendix of nearly 1,500 pages comprised of, *inter alia*, 75 trial exhibits, the Eighth Circuit held that "[t]he class presented evidence of a sufficient 'causal nexus' between CDC's improper [conduct] and the drop in CDC's stock price, so that a reasonable jury could find causation." *In*

re Control Data Corp. Securities Litigation, 933 F.2d 616, 621 (8th Cir. 1991). Accordingly, the Court of Appeals remanded the case to the district court for a plenary trial. Although defendants strain to contrive a basis for this Court to grant certiorari, nothing in the opinion of the Eighth Circuit raises a question any more novel than whether plaintiffs offered sufficient evidence of causation in support of their claims under Rule 10b-5 so that a jury should be allowed to consider them.

The lawsuits which comprise this consolidated class action were brought after CDC, at the insistence of the Securities and Exchange Commission ("SEC"), announced on August 6, 1985 that it was restating its previously reported financial results for its fiscal year ending December 31, 1984. As a result of the restatement, CDC's reported earnings declined by 84 percent, from $31.6 million to $5.1 million, and per share earnings were reduced from $0.81 to $0.12. The restatement of earnings for 1984 resulted from the reversal of two accounting decisions made by CDC, and approved by Peat Marwick, which were seriously challenged by the SEC. The major portion of the restatement was based upon the reversal of a claimed $16.8 million net operating loss ("NOL") carryforward tax benefit arising from CDC's decision to discontinue a certain product line within its computer peripherals business. The restatement was also undertaken as a result of the SEC's belief that $9.7 million in losses sustained by one of CDC's affiliated companies that were charged to retained earnings should have been recognized in CDC's income statement. Plaintiffs alleged that these accounting decisions were made in violation of generally accepted accounting principles ("GAAP") and that Peat Marwick failed to conduct its year-end audit of CDC in accordance with generally accepted auditing standards ("GAAS").[1]

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1. In addition to their allegations of accounting improprieties, plaintiffs, in their Consolidated Complaint filed in December 1985 and in their responses to defendants' contention interrogatories

The investment community did not become aware of the full implications of the August 6, 1985 restatement until five business days later when, on August 13th, *The Wall Street Journal* reported that the restatement had caused CDC to be in default of revolving credit agreements with its lending banks. These revolving credit agreements were a critical source of short-term financing for the Company. The default occurred when the restatement caused CDC to violate the terms of loan covenants in these agreements which required the Company's financial condition to be maintained at certain minimum levels. With this announcement, the price of CDC stock experienced a sharp decline of $3.00 per share in heavy trading.

The nature of plaintiffs' evidence as to the causation element of their Rule 10b-5 claim, which was carefully analyzed by the Court of Appeals, is best understood in the context of the severe financial crisis in which CDC found itself at the time defendants elected to engage in fraudulent accounting manuevers in late 1984 and early 1985. Plaintiffs offered substantial evidence at trial which chronicled the steep decline of CDC's financial condition during 1984. The most profound problems for CDC were occurring in its computer peripherals disk drive business, the Company's largest revenue producer of its four main business segments. As characterized by defendant Robert M. Price, CDC's Chief Operating Officer, the industry was undergoing an "enormous restructuring" which was fundamentally changing the nature of the peripherals disk drive business. In 1984,

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NOTES *(Continued)*

served in December 1988, alleged numerous other independent grounds for charging defendants with violations of Rule 10b-5. For example, plaintiffs alleged that during the Class Period, defendants misled investors about the status of CDC's compliance with its loan covenants, issued projections of financial performance which were without reasonable basis and failed to disclose that serious problems were plaguing the Company's key peripherals business. These matters are not before the Court.

many new foreign competitors entered the market and, within a few short months, CDC was experiencing severe price erosion in a number of its product lines. The pressure on CDC's peripherals business further intensified in the fall of 1984 when a large increase in order cancellations and shipment deferrals by major customers heralded the arrival of a softening market. Finally, CDC itself contributed greatly to these problems because its manufacturing costs were excessively high, the quality of its products was not up to world competitive levels and the Company suffered from a chronic inability to develop and deliver new products into the marketplace in a timely manner.

The confluence of all of these negative trends caused CDC's inventories to skyrocket in 1984. In order to finance its mounting inventories, CDC was forced to incur unprecedented levels of debt. As a condition for committing lines of credit totalling $300 million, the Company's lenders required CDC to agree to abide by the terms of several different loan covenants. Among other things, the loan covenants required CDC's computer business to maintain a minimum net worth of $900 million and a debt to equity ratio of .9 to 1, and limited CDC's right to declare dividends. The banks were entitled to declare the Company in default of its revolving credit agreements upon violation of any one of these covenants.

By the end of 1984, CDC's financial condition had deteriorated so badly that the Company was on the brink of an impending default. As plaintiffs demonstrated at trial, the prospects for default were seriously considered by CDC's senior management and Peat Marwick, but were never disclosed to the Company's shareholders. For example, in early December 1984, CDC reported to Peat Marwick in connection with the year-end audit that "debt covenant restrictions are very close" and that it was "putting programs in place to manage assets and cash flow requirements." Similarly, at a CDC Management Committee meeting held on January 2-5, 1985,

defendant Price, while excoriating his senior management for submitting "irresponsible" 1985 budgets, also expressed his concern that CDC had "serious problems with [its] bank covenants." At the same meeting, CDC's corporate controller "demonstrate[d] the seriousness of the problem" and stated that "[i]f we are to avoid being in default of our bank covenants, we must either increase earnings or reduce our debt." While CDC and Peat Marwick acknowledged internally "the seriousness of the problem," the investing public remained unaware of the true state of the Company's financial condition. Indeed, as recently as November 1984, at a meeting of security analysts, the Company's Chief Financial Officer, defendant Marvin G. Rogers, misled investors by proclaiming that CDC was "stronger financially than it's been during most of its history."

Defendants contrived to maintain this fiction at a meeting which the Company held with its bankers on December 12, 1984. In order to mollify the bankers' concerns, CDC told them that the Company's 1984 earnings would be $0.80 per share and that it expected to earn $4.00 per share in 1985. The Company later disseminated these identical figures to the public in a press release dated January 4, 1985 (the last business day before the beginning of the Class Period). CDC's release of 1984 earnings to the bankers and the public occurred significantly before Peat Marwick had substantially completed its year-end audit of the Company. Nevertheless, since the $0.80 per share figure varied by only one penny from Control Data's actual, unrestated 1984 earnings, there can be no doubt that this figure was the product of the improper NOL tax benefit and retained earnings accounting decisions at issue in this litigation.

Not only did the two accounting adjustments dramatically increase the Company's earnings, but the balance sheet effect of the $16.8 million NOL carryforward tax benefit afforded CDC some much needed

breathing room in complying with its loan covenants.[2] In February 1985, defendant Rogers sent a memorandum to defendant Price which listed "CDC financing/ default avoidance" as his No. 1 priority for 1985. Rogers' concern with "default avoidance" was graphically illustrated by an attachment to this memorandum which showed that as of January 31, 1985, CDC had a net worth of approximately $915 million. If CDC had not availed itself of the $16.8 million NOL tax benefit, the Company's net worth would have been reduced to below the $900 million minimum required by one of its loan covenants. Thus, but for defendants' decision to record the NOL tax benefit, CDC would have been in default of its revolving credit agreements by at least as early as January 31, 1985. Clearly, defendants' fraudulent accounting was designed to conceal the precarious state of CDC's financial condition from the investing public.

As 1985 unfolded, the negative trends which had commenced during the previous year intensified and CDC's financial condition declined even more rapidly. The Company planned a $300 million debt offering for September 1985, the proceeds of which were to have been used to repay its short-term bank debt. However,

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2. CDC's recognition of the NOL tax benefit, and Peat Marwick's certification thereof, was particularly egregious. The applicable generally accepted accounting principles governing NOL carryforward tax benefits are contained in Opinion No. 11 of the Accounting Principles Board of the American Institute of Certified Public Accountants ("APB No. 11"). Under APB No. 11, such a tax benefit may not be recognized unless certain conditions are assured "beyond any reasonable doubt." In its Staff Accounting Bulletin No. 40, the SEC characterized the "beyond any reasonable doubt" standard of APB No. 11 as "one of the most restrictive tests within the authoritative literature." Plaintiffs offered ample evidence at trial that CDC could not possibly satisfy this extremely strict test and the district court found that there was sufficient evidence of GAAP and GAAS violations by defendants. (Petitioners' Appendix at 15a-16a). All of this evidence was also presented to the Court of Appeals, which carefully analyzed it in reaching its factual decision that plaintiffs' case should be allowed to be considered by a jury.

the offering was abruptly cancelled after it was determined that CDC's business had deteriorated even more substantially than described in the offering documents. After the cancellation of the offering, CDC's lenders refused to extend further temporary waivers of default that had been granted when the Company restated its 1984 financial results. In order to stave off possible involuntary bankruptcy proceedings, the Company entered into a protracted period of painful negotiations with its lending banks to restructure the revolving credit agreements. The Company was required to cancel its fourth quarter dividend payment on common stock and it ended 1985 with a staggering loss of more than a half a billion dollars.

Against the backdrop of the grave and undisclosed state of CDC's financial condition that existed in late 1984 and 1985, the "causal link" between defendants' accounting improprieties and the losses of the shareholder class is clear. Defendants' misconduct effectively forestalled disclosure of an impending default for a period of approximately eight months. As the Eighth Circuit correctly observed, "CDC would be liable if its improper accounting concealed the company's net worth and debt-equity ratio and inflated the price of CDC stock by obscuring the company's risk of default on its loan covenants." 933 F.2d at 620. Since plaintiffs' expert opined that precisely this situation had occurred, *see* 933 F.2d at 20 n.8, the Eighth Circuit held that the district court erred in granting a directed verdict for defendants. The Eighth Circuit did not rule that plaintiffs had, in fact, proven causation. Rather, it simply held that "plaintiffs should be allowed to test that claim before a jury." 933 F.2d at 620 n.10. Clearly, the Eighth Circuit decided no issue other than the sufficiency of the evidence offered by plaintiffs at trial.

SUMMARY OF ARGUMENT

There is no need to grant certiorari to decide any of the issues raised by Petitioners. As demonstrated below, the "Questions Presented" by Petitioners simply do not relate to this case or the decision of the Court of Appeals below. Contrary to the issues set forth in the Petition, the Court of Appeals did *not* eliminate loss causation as an element of a Section 10(b) claim, did *not* create a presumption of loss causation and did *not* make any finding as to the circumstances under which the presumption of reliance under the fraud-on-the-market theory may be rebutted. Petitioners' request that this Court immerse itself in the minutia of an immense record, consisting of thousands of pages of trial transcripts, trial exhibits and deposition transcripts, to determine the sufficiency of the evidence should be rejected.

Petitioners' contention that the Eighth Circuit's opinion somehow eliminates "loss causation" as an element of a Rule 10b-5 claim or grants plaintiffs a presumption of causation is simply untrue. The Court made no such ruling and plaintiffs never requested it to do so. The Court of Appeals clearly held that "it is settled" that "causation," among other matters, is an "essential element[] of a Rule 10b-5 claim." 933 F.2d at 618. The Eighth Circuit further held that causation must be demonstrated by "show[ing] some 'causal nexus' between CDC's improper conduct and plaintiffs' losses." 933 F.2d at 619. The Court of Appeals' reversal of the district court was founded upon a straightforward determination that based on the evidence presented at trial, plaintiffs were entitled to have a jury decide whether a causal relationship existed between defendants' accounting improprieties and the losses of the shareholder class. After articulating the standard for proving the causal nexus between defendants' misconduct and plaintiffs' losses, which is the same standard applied by all other courts, the Court analyzed the evidence, including the testimony of plaintiffs' expert,

and concluded that "[t]he class presented evidence of a sufficient 'causal nexus' between CDC's improper accounting and the drop in CDC stock price, so that a reasonable jury could find causation." 933 F.2d at 621. The opinion neither eliminates loss causation as an element of a Rule 10b-5 claim, nor creates a presumption of loss causation. The Eighth Circuit has done nothing more than require that plaintiffs' evidence be weighed by a jury. As such, the opinion does not conflict with any decision of this Court or any other appeals court.

Defendants also contend that review of this case is necessary to obtain additional guidance as to the circumstances under which the presumption of the "reliance" element of a Rule 10b-5 claim accorded a plaintiff under the "fraud-on-the-market" theory, as articulated by this Court in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), may be rebutted. The Eighth Circuit's opinion does not in any way mark a departure from this Court's decision in *Basic*. While Petitioners might be interested in further guidance as to when presumption of reliance may be rebutted, and while the matter is certainly academically interesting, it is clear that neither the district court nor the Eighth Circuit addressed this issue. Since Petitioners concede in their Petition that they did not raise the question of the circumstances under which the presumption of reliance may be rebutted before the Eighth Circuit, review of the issue by this Court is not warranted.

Finally, this case is simply not ripe for consideration by the Supreme Court. All that has occurred is that the Court of Appeals has sent the case back to the district court for trial. Defendants have presented no evidence, a jury has not even considered plaintiffs' claims and, therefore, neither the district court nor the Court of Appeals has ruled on the sufficiency or propriety of any verdict. It would thus be premature for this Court to consider this case.

ARGUMENT WHY THE PETITION SHOULD BE DENIED

I. THE EIGHTH CIRCUIT'S OPINION NEITHER ELIMINATES LOSS CAUSATION AS AN ELEMENT OF A RULE 10b-5 CLAIM NOR CREATES A PRESUMPTION OF LOSS CAUSATION; THE OPINION DOES NOT CONFLICT WITH ANY DECISION OF THIS COURT OR ANY OTHER APPEALS COURT

It is hard to understand how Petitioners can contend that the Court of Appeals below has eliminated the element of loss causation or presumed it. It did neither. Citing its earlier decision on the issue of loss causation in *Harris v. Union Electric Co.*, 787 F.2d 355, 366 (8th Cir.), *cert. denied*, 479 U.S. 823 (1986), the Court clearly held that it was "settled" that causation is an "essential element[] of a Rule 10b-5 claim." 933 F.2d at 618. In *Harris*, the Eighth Circuit, just as other circuits before it and since, explicitly discussed both "transaction causation" and "loss causation," finding that a plaintiff must prove each. As the *Harris* court observed:

> Several courts . . . distinguish between "transaction causation" and "loss causation" and require the plaintiff to establish both. Transaction causation is established when the plaintiff shows that the defendant's fraudulent conduct caused the plaintiff to engage in the transaction in question. This is nothing more than "but for" causation, which is merely another way of describing reliance. *Loss causation, on the other hand, is the nexus between the defendant's fraudulent conduct and the plaintiff's pecuniary loss.* (citations omitted) (emphasis added).

787 F.2d at 366. After reviewing the evidence of transaction causation, the *Harris* court stated that "[i]n addition . . ., the plaintiffs were also required to prove loss causation." *Id.* at 367. The court then went on to

engage in a detailed evidentiary analysis of loss causation and damages, *Id.* at 367-68, and affirmed the jury's verdict for plaintiffs on their Section 10(b) claim.[3] *See also, Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1327-1328 (8th Cir. 1991).

Courts have distinguished between transaction causation and loss causation in recognition of the fact that a defendant should not be held liable for that portion of a security's decline in value which is unrelated to the disclosure of the defendant's misrepresentations. *See, e.g., Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part, rev'd in part*, 459 U.S. 375 (1983) ("If the investment decision is induced by misstatements or omissions that are material and that were relied on by the claimant, but are not the proximate reason for his pecuniary loss, recovery under the Rule is not permitted."); *In re Washington Public Power Supply System Securities Litigation*, 650 F.Supp. 1346, 1353 (W.D. Wash. 1986). Thus, a plaintiff must prove that the decision to purchase was induced by a defendant's misrepresentations *and* that those misrepresentations are causally related to the plaintiff's losses. This is exactly what the Eighth Circuit required plaintiffs herein to prove.

Defendants never challenged before the Court of Appeals the fact that plaintiffs had demonstrated "transaction causation" or "reliance" by invoking the fraud-on-the-market theory. As Petitioners themselves admit at page 11 of their Petition, "that [issue] was not contested on appeal." Under the fraud-on-the-market theory, this Court has held that "the reliance of individual plaintiffs on the integrity of the market price [of a given stock] may be presumed" where "materially misleading statements have been disseminated into an impersonal, well

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3. Petitioners' distortion of the *Harris* case in an effort to manufacture a conflict between the Eighth Circuit and other circuit courts is incomprehensible. Their citation of the decision in *Harris* for the proposition that "[t]he Eighth Circuit has, with respect to the [*Affiliated*] *Ute* presumption as well as that of *Basic*, apparently concluded that the presumption of reliance eliminates the need for actual proof of loss causation," Petitioners' Brief at 12 n.10, is belied by the facts and even a cursory reading of *Harris*.

developed market for [the] securities." *Basic, Inc. v. Levinson, supra*, 485 U.S. at 247. The Eighth Circuit in its opinion recognized that transaction causation:

> lies in the fact that the plaintiff relied on the market price of the security as an indicator of the future value of the stock. To the extent that the defendant's misrepresentations artificially altered the price of the stock and defrauded the market, causation is presumed. *See, Basic, Inc. v. Levinson*, 485 U.S. 224, 247 (1988) ("Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for the purposes of a Rule 10b-5 action.").

933 F.2d at 620. This conclusion is based directly on this Court's holding in *Basic*, and is in accord with the decisions of all circuits. *See, e.g., Peil v. Speiser*, 806 F.2d 1154, 1161 (3d Cir. 1986); *Harris v. Union Electric Co., supra*, 787 F.2d at 367, and n.9; *Ross v. A.H. Robins Co.*, 607 F.2d 545, 553 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); *Blackie v. Barrack*, 524 F.2d 891, 905-908 (9th Cir. 1985), *cert. denied*, 429 U.S. 816 (1976).

However, the reference by the Court of Appeals to reliance or transaction causation had no bearing on its decision to reverse the granting of the directed verdict. For the Court then went on to consider whether plaintiffs had met the standard for proving loss causation — whether there was "some causal nexus between CDC's improper conduct and plaintiffs' losses." 933 F.2d at 619. This inquiry not only does not conflict with any other circuit's inquiry, but is the same standard considered by the other circuits in determining loss causation.[4]

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4. Petitioners themselves admit this when they state at page 11 of their Petition as follows:

> Loss causation, on the other hand, establishes "that the misrepresentations or omissions caused the economic harm." *Schlick v. Penn-Dixie Cement Corp., supra*, 507 F.2d at 380.

The Court of Appeals analyzed the question of whether plaintiffs offered evidence of the required "causal nexus" between defendants' alleged improper conduct and the losses suffered by the shareholder class as follows:

> A jury could reasonably find that CDC's improper accounting artificially altered the price of CDC stock in a variety of ways. Perhaps most obviously the improper accounting inflated 1984 actual earnings and 1985 projected earnings, figures that investors may have considered important in making investment decisions. However, the improper accounting also altered CDC's true net worth and debt-equity ratio. Plaintiffs' expert testified that these figures are financial indicators that would be important to investors because of what they reveal about the status of CDC's loan covenants.

933 F.2d at 620 (footnotes omitted). Thus, the Court of Appeals reviewed two possible factual bases for loss causation and examined whether any evidence presented at trial supported them. Included among the evidence before the Eighth Circuit was the undisputed fact that the price of CDC stock fell by $3.00 when it was disclosed that the restatement had caused the Company to be in default of its loan covenants, and the testimony

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NOTES *(Continued)*

See also Bastian v. Petren Resources Corp., supra, 892 F.2d at 685; *Currie v. Cayman Resources Corp., supra,* 835 F.2d at 785. In the words of the Fifth Circuit, " 'loss causation' refers to a direct causal link between the misstatement and the claimant's economic loss." *Huddleston v. Herman & MacLean, supra,* 640 F.2d 534, 549 n.24 (5th Cir. 1983), *aff'd in part and rev'd* in part on other grounds, 459 U.S. 375 (1983).

The standards set forth by the other circuits are the same as applied by the Eighth Circuit here. Compare, for example, *Huddleston's* requirement of a "causal link between the misstatement and the claimant's economic loss" with the requirement of the court below that plaintiffs demonstrate a "causal nexus between CDC's improper conduct and plaintiffs' losses."

of plaintiffs' expert that this decline in stock value was the result of the revelation of material information regarding CDC's financial condition which defendants' accounting decisions had concealed. The Eighth Circuit determined that this evidence was sufficient to support the theory that defendants' accounting improprieties caused losses to the shareholder class by concealing the status of CDC's compliance with its loan covenants.

Far from ignoring or presuming "loss causation", the Court of Appeals concluded that "[t]he class presented evidence of a sufficient 'causal nexus' between CDC's improper accounting and the drop in CDC stock price, so that a reasonable jury could find causation." 933 F.2d at 621. The Court therefore remanded the case for a new trial, noting that the "[d]etermination of whether a misrepresentation would have the effect of defrauding the market and inflating the stock price is a jury question." *Id.* Clearly then, the Eighth Circuit did not hold that loss causation may be presumed. Nor did it eliminate loss causation as an element of a Rule 10b-5 claim. Nor, in fact, did it announce any principle of law whatsoever. The Eighth Circuit's opinion unquestionably requires plaintiffs to present actual evidence of loss causation and, in this case, it found that the evidence was sufficient to entitle plaintiffs to have a jury hear their claims.

Defendants' attempt to have this Court believe that there is a conflict among the circuits on the necessity of proving loss causation must fail. No appeals court has held that loss causation need not be proven. In *Bastian v. Petren Resources Corp.*, 892 F.2d 680 (7th Cir.), *cert. denied*, 110 S.Ct. 2590 (1990), a case upon which Petitioners' rely heavily, the Seventh Circuit discussed the loss causation requirement and cited numerous cases on the issue. None of the circuit court cases referred to by the Seventh Circuit or those cited by Petitioners eliminate the need to prove loss causation or state that it can be presumed. All of the relevant circuit decisions, including *Bastian* and the decision below,

require proof of loss causation. *See e.g., Bruschi v. Brown,* 876 F.2d 1526, 1531 (11th Cir. 1989) (loss causation requirement "satisfied when a defendant makes representations that are inherently related to the losses the purchaser subsequently suffers."); *Bennett v. United States Trust Co.,* 770 F.2d 308, 314 (2d Cir. 1985), *cert. denied,* 474 U.S. 1058 (1986) (requiring "direct or proximate relationship between the loss and the misrepresentation."); *Huddleston v. Herman & MacLean, supra,* 640 F.2d at 549 (misrepresentation must touch "upon the reasons for the investment's decline in value.") *Marbury Management, Inc. v. Kohn,* 629 F.2d 705, 708 (2d Cir. 1980), *cert. denied,* 449 U.S. 1011 (1980) ("the damage complained of [must] be one of the foreseeable consequences of the misrepresentation."). Defendants have failed to demonstrate the existence of any conflict as to whether loss causation is an element of a Rule 10b-5 claim.

II. THIS CASE PRESENTS NO OCCASION FOR THIS COURT TO DETERMINE THE CIRCUMSTANCES UNDER WHICH THE PRESUMPTION OF RELIANCE ON THE INTEGRITY OF THE MARKET MAY BE REBUTTED

In a last ditch attempt to concoct a basis to obtain review of this case, defendants also assert that this Court should exercise its supervisory power to clarify the circumstances under which the fraud-on-the-market theory's presumption of reliance may be rebutted. This argument was not raised in the court below by defendants, was not briefed below by any party, was not addressed by either the district court or the Court of Appeals and played no part in the decision of either the district court or Court of Appeals. This is admitted by defendants in their Petition at page 11 ("fraud on the market, a concept of reliance that was not contested on appeal . . ."). As such, review of the question by this Court would be inappropriate. *See, e.g. Price Waterhouse v. Hopkins,* 490 U.S. 228, 240 n.5 (1989); *G.D. Searle &*

Co. v. Cohn, 455 U.S. 404, 412 n.7 (1982); *Delta Airlines v. August,* 450 U.S. 346, 362 (1981).

Moreover, Petitioners' argument reflects their continued misunderstanding of the Court of Appeals decision. Contrary to the question presented by Petitioners, the Court did not state that the market price of CDC stock was unaffected by disclosure of the alleged unlawful acts of defendants. It recognized that evidence had been presented of exactly the opposite. In any event, the Court did not hold that defendants are precluded from attempting to rebut the fraud-on-the-market reliance presumption. All that it held was that plaintiffs should be allowed to have their case heard by a jury. At the trial, defendants can put forward whatever competent and relevant evidence they have as to reliance. Review of the circumstances under which the presumption of reliance on the integrity of the market may be rebutted is simply inappropriate at this juncture.

III. NEITHER OF THE ISSUES RAISED BY PETITIONERS ARE RIPE FOR REVIEW

Review of the issues raised by Petitioners is unwarranted because the factual record in this case is not sufficiently developed. The Court of Appeals has made no finding or determination of law or fact which it has applied to Petitioners. All it has done is to hold that the district court erred in granting a directed verdict to defendants and that, under the particular facts adduced at trial, a jury should be allowed to consider plaintiffs' claim that defendants' improprieties caused losses to the shareholder class, as well as any evidence which defendants may offer in defense of these claims. While Petitioners seek clarification as to the circumstances under which the presumption of reliance may be rebutted, they have yet to offer any evidence of their own on this question. Similarly, while Petitioners attack the Eighth Circuit's ruling that plaintiffs have presented evidence as to loss causation, they have yet to offer any

evidence of their own disputing it. Only after a jury has considered the evidence presented by all parties and after both the district court and Court of Appeals have considered the sufficiency or propriety of a verdict by the jury, will this case, if ever, be ripe for consideration by this Court. Clearly, this case is not ripe for review until all issues have been litigated at trial and argued on appeal.

CONCLUSION

For all of the foregoing reasons, the petition for writ of certiorari should be denied.

Dated: October 24, 1991

Respectfully submitted,

Leonard Barrack
(Counsel of Record)
Sheldon L. Albert
Robert A. Hoffman
Barrack, Rodos & Bacine
Suite 2100
1845 Walnut Street
Philadelphia, PA 19103
(215) 963-0600

Jack L. Chestnut
Karl L. Cambronne
Chestnut & Brooks, P.A.
3700 Piper Jaffray Tower
222 South Ninth Street
Minneapolis, MN 55402
(612) 339-7300

Attorneys for Respondents

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No. 91-488

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

KPMG PEAT MARWICK, CONTROL DATA CORPORATION, NORBERT R. BERG, WILLIAM C. NORRIS, ROBERT M. PRICE, and MARVIN G. ROGERS,
Petitioners,

—v.—

DIANE ABBEY, DAVID WEISGAL, WILLIAM STEINER, WILLIAM RANDALL, and JOHN PAGE,
Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

REPLY BRIEF IN FURTHER SUPPORT OF PETITION

STEVEN J. OLSON
A. REID SHAW
Control Data Corporation
Attorneys for Control Data Corporation

CRAIG W. GAGNON
MICHAEL J. BLECK
OPPENHEIMER WOLFF & DONNELLY
Attorneys for Individual Petitioners

*Counsel of Record

*DEAN I. RINGEL
ADAM LIPTAK
CAHILL GORDON & REINDEL
(a partnership including a professional corporation)
80 Pine Street
New York, New York 10005
(212) 701-3000
Attorneys for Petitioners

ELLIOT S. KAPLAN
DEBORAH J. PALMER
ROBINS, KAPLAN, MILLER & CIRESI

PHILIP A. BROWN
VORYS, SATER, SEYMOUR AND PEASE

LEONARD P. NOVELLO
General Counsel
EDWIN D. SCOTT
Associate General Counsel
KPMG PEAT MARWICK
Attorneys for KPMG Peat Marwick

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Reference is made to Petitioners' statement pursuant to Rule 29.1 at page ii of the Petition for a Writ of Certiorari.

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

REPLY BRIEF IN FURTHER SUPPORT OF PETITION

This reply brief responds to the three principal arguments first advanced by respondents in their brief in opposition ("Br. Op.").

I.

This Petition Directly Presents The Fundamental And Unresolved Question Of Whether An Action Under Rule 10b-5 Requires Actual Proof Of Loss Causation, *i.e.*, A Direct Link Between The Asserted Misrepresentation And The Alleged Injury

This Petition presents directly, and on a fully developed and clear trial record, significant legal issues as to the nature of the causation required to establish a claim for damages

under Rule 10b-5, 17 C.F.R. § 240.10b-5 (1991). Respondents assert that the Eighth Circuit "did not issue any ruling of law whatsoever" and seek to characterize the Petition as posing no more than "the routine factual question of whether plaintiffs adduced sufficient evidence at trial to allow their claims to be heard by a jury." Br. Op. 1. In fact, however, the opinion below explicitly turned on the adoption of a specific legal standard of causation, one expressly stated to be at variance with that applied by the district court in dismissing the case at the close of Respondents' proof.

> "We find the district court's view of causation too narrow under legal principles governing Rule 10b(5) cases. Plaintiffs are not required to meet a strict test of direct causation under Rule 10b-5; they need only show 'some causal nexus' between CDC's improper conduct and plaintiff's losses." (933 F.2d at 619; Appendix to the Petition ("App") at 6a)

Respondents' brief in opposition quotes the Eighth Circuit's general "causal nexus" language on several occasions (Br. Op. at 9, 13), but wholly fails to quote or even refer to the explicit rejection of the "direct causation" requirement reflected in the same sentence of the court's opinion. Such "direct causation," the standard adopted by the district court and rejected by the court of appeals, is the "loss causation" referred to by courts in other circuits.[1]

Nor, despite Respondents' efforts, can the Eighth Circuit's opinion otherwise be read to accept the usual understanding of "loss causation." Thus, although the opinion does indeed agree that it is "settled" that "*causation*" is an "essential element of a Rule 10b-5 claim," the court's opinion nowhere distinguishes between loss causation and transaction causa-

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1 *See, e.g., Huddleston* v. *Herman & MacLean*, 640 F.2d 534, 549 n.24 (5th Cir. 1981) (" 'loss causation' refers to a *direct causal link* between the misstatement and the claimant's economic loss"), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983) (emphasis added).

tion in the passage referred to by Respondents (Br. Op. at 13) or elsewhere in the opinion. Indeed, although Respondents imply that the court of appeals made such a distinction when it defined causation in terms drawn from this Court's analysis of *reliance* in *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988), it is Respondents who add the modifier "transaction" to the word causation in setting out the quotation from the Eighth Circuit's opinion. Br. Op. at 12-13. The opinion itself refers only to "causation," equating such causation with the satisfaction of the *Basic* standard.[2] (933 F.2d at 618, 619-20; App. 4a, 7a) The legal issue, then, could hardly be clearer: is direct proof of causation, *i.e.*, loss causation, a required element of a Rule 10b-5 claim?

Respondents do what they can to suggest that this case requires resolution of a myriad of factual issues and therefore that resolution of the legal issues posed is not appropriate now. But the opinions of each of the courts below recognized the undisputed status of the key evidence. Plaintiffs' own expert conceded that the market price of the Control Data Corporation ("CDC") stock in question was not affected by the announcement of the restatement of earnings. (933 F.2d at 618-19; App. 4a-6a, 16a) This was, as the district court recognized, a concession that no damages were caused by the alleged misrepresentation. (App. 16a) The district court attached controlling significance to this conceded fact, a fact to which the brief in opposition does not even refer. *Id.*

The court of appeals also accepted this undisputed fact. (933 F.2d at 619; App. 5a-6a) It concluded, however, that since a price drop did occur a week later, after reports about CDC's technical violation of certain loan covenants were published, the jury should be allowed to consider whether that later loss could be attributed to the original misstatement of income. It reached this conclusion even though the pub-

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2 As a second line of defense, the brief in opposition dismisses the Eighth Circuit's linkage of "causation" to the standards for reliance as having "no bearing on [the court's] decision to reverse the granting of the directed verdict." Br. Opp. at 13. This is an extraordinarily blithe dismissal of the Eighth Circuit's own contrary language.

lished restatement of income itself produced no change in the stock price and even though the district court held—and the court of appeals agreed—that no evidence of any duty to disclose information about the loan covenants had been presented.[3] (933 F.2d at 620; App. 6a)

The factual record is thus plain and undisputed in the relevant aspects. It allows this Court to determine whether direct proof of loss causation is required or whether, as the court of appeals' analysis suggests, the mere existence of evidence of an alleged misrepresentation and of any subsequent loss without more provides a sufficient legal "nexus" to permit a jury to consider a claim of causation.[4]

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3 Significantly, the district court held that any theory of causation premised on the failure to disclose information pertaining to the loan covenants was barred by Respondents' pre-trial acceptance of the bounds of their case as limited to "misstatements of income." (933 F.2d at 621; App. 10a) The district court excluded expert testimony as to whether any duty existed to disclose information as to the loan covenants and the court of appeals affirmed on this point. (933 F.2d at 621-22; App. 9a-11a) That Respondents from the first approached this as a restatement of income case unrelated to the loan covenants is perhaps most tellingly illustrated by the fact that this suit was brought on August 8, 1985—the day after the first Wall Street Journal article appeared. That article described the restatement of income; unlike the later article, it made no mention of the loan covenants.

4 The Eighth Circuit's own speculation about how the alleged improprieties could have caused injury itself illustrates the problem that arises when there is no requirement that a specific misrepresentation be tied to a particular loss. (933 F.2d at 620; App. 7a) The court of appeals readily acknowledged that the inflation of actual earnings and projected earnings "most obviously" may have been considered "important" in making investment decisions. *Id.* But, as the court recognized, the restatement of such figures, in fact, produced no change in the stock price. (933 F.2d at 620; App. 8a) The court therefore proceeded to speculate on other ways that the alleged misrepresentations may have affected investors' decisions, all in the face of its recognition that "the misrepresented earnings figures did not affect the stock price." *Id.* It is difficult to imagine a clearer instance of an appellate court granting a jury a roving commission to find causation for an injury rebutted by the record itself.

II.

The Second Question Is Properly Presented, Having Been First Framed By The Court Of Appeals In Ruling That the Fraud-On-The-Market Presumption Cannot Be Rebutted With Evidence That The Misrepresentation Alleged "Did Not Affect The Stock Price"

Respondents concede the importance—to this action, to the lower federal courts and to practitioners—of additional guidance from this Court on the vexing question of whether and how the fraud-on-the-market presumption of reliance announced in *Basic Inc.* v. *Levinson*, *supra*, may be rebutted. Br. Op. at 10. But they urge this Court to put off consideration of this question to another day as a matter of discretion, solely on the ground that it has not been sufficiently preserved for review. Br. Op. at 10, 16-17.

Petitioners had no occasion to raise this issue until now. Only the court of appeals' reversal of the district court's grant of a directed verdict as to the element of causation coupled with its simultaneous acknowledgment that "the misrepresented earnings figures did not affect the stock price" (933 F.2d at 620; App. 8a) framed the issue as to which review is sought: can the fraud-on-the-market presumption *ever* be rebutted if even proof that the asserted misrepresentation failed to affect the price of the security in question is insufficient. This Court has recognized that when, as here, the court below passed on the question presented it is fully preserved for review. *See City of Springfield* v. *Kibbe*, 480 U.S. 257, 259, 266 (1987) (per curiam) (O'Connor, J., dissenting), and cases cited therein; R. Stern, E. Gressman & S. Shapiro, *Supreme Court Practice* 364 (6th ed. 1986), and cases cited therein.

III.

The Fully Developed Trial Record In This Case Presents An Ideal Posture For Resolution Of The Questions Presented

Respondents advance the argument that the questions presented by the Petition are not "ripe for review" because "the factual record in this case is not sufficiently developed." Br. Op. at 17. This assertion could not be more wrong: this is the rare case where review by this Court is sought after plaintiffs in a securities fraud action have had the opportunity to present *all* of their evidence *at trial*. That evidence provides a full context in which to assess the correctness of the legal standard applied by the Eighth Circuit. Indeed, the clarity of the record as to the crucial fact establishing the absence of loss causation—the failure of the market to react to the restatement of earnings—provides an unusually "clean" predicate for the Court's legal assessment.

By contrast, many of this Court's notable decisions in the Rule 10b-5 context have been made on far less developed records in pre-trial settings. *See Lampf, Pleva, Lipkind, Prupis & Petrigow* v. *Gilbertson*, 111 S. Ct. 2773 (1991) (summary judgment); *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988) (certification of class action); *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977) (dismissal of complaint for failure to state a claim); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) (summary judgment); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975) (dismissal of complaint for failure to state a claim).

The procedural posture of this case lends itself to a full exploration of the issues posed. The case is ripe for this Court's review.

CONCLUSION

For the foregoing reasons and the reasons set forth in the Petition, the petition for a writ of *certiorari* should be granted.

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Respectfully submitted,

STEVEN J. OLSON
A. REID SHAW
Control Data Corporation

Attorneys for Control Data Corporation

CRAIG W. GAGNON
MICHAEL J. BLECK
OPPENHEIMER WOLFF & DONNELLY

Attorneys for Individual Petitioners

*DEAN I. RINGEL
ADAM LIPTAK
CAHILL GORDON & REINDEL
(a partnership including a professional corporation)
80 Pine Street
New York, New York 10005
(212) 701-3000

Attorneys for Petitioners

ELLIOT S. KAPLAN
DEBORAH J. PALMER
ROBINS, KAPLAN, MILLER & CIRESI

PHILIP A. BROWN
VORYS, SATER, SEYMOUR AND PEASE

LEONARD P. NOVELLO
General Counsel
EDWIN D. SCOTT
Associate General Counsel
KPMG PEAT MARWICK

Attorneys for KPMG Peat Marwick

**Counsel of Record*